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In The

# Supreme Court of the United States

October Term, 1988

EDWARD C. ABELL, JR. AND CAREY WALTON, INDIVIDUALLY AND AS REPRESENTATIVES OF THE CLASS OF PURCHASERS OF WESTSIDE HABILITATION CENTER REVENUE BONDS,

*Petitioners,*

versus

WRIGHT, LINDSEY & JENNINGS, VALLEY FORGE INSURANCE COMPANY AND JOE E. FRYAR,

*Respondents.*

**On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit**

## PETITION FOR A WRIT OF CERTIORARI

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# I.
# QUESTIONS PRESENTED

1. *Attorney Liability For Securities Fraud:*

Where an attorney is engaged by the underwriters to ensure full disclosure of all material information to the investing public in connection with a public offering of revenue bonds, the attorney knows that the principal purpose of the engagement is to protect the investing public by providing adequate disclosure, the attorney performs the engagement in a grossly reckless manner, ignoring obvious signs of fraudulent conduct that result in substantial damage to the investing public, and the attorney's name is included on the cover of the offering document as the lawyer that certified its adequacy, should a court absolve the attorney of any liability under Section 10(b) of the Securities Exchange Act of 1934 on the ground that the attorney owed no duty to the public to ensure adequate disclosure?

2. *Denial Of Presumptions To Defrauded Class:*

a. Where the offering documents contain material misrepresentations *and* omissions, should a court hold that the existence of any affirmative misrepresentation prevents the plaintiff class from obtaining the benefit of the presumption of "reliance" under § 10(b) of the Securities Exchange Act of 1934 recognized by this Court in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 92 S. Ct. 1456 (1972)?

## QUESTIONS PRESENTED (Cont.)

b. Where unrefuted expert testimony establishes that newly issued securities could not have been marketed but for the fraud of defendants and that the securities traded on an active, efficient secondary market which publishes daily offering prices, should the plaintiff class be denied the presumption of "reliance" under the fraud-on-the-market theory recognized in *Basic Inc. v. Levinson*, ___ U.S. ___, 108 S. Ct. 978 (1988), on the ground that the plaintiff class did not prove that at commencement of the initial offering the promoters knew that the enterprise was a hoax?

## II.

## LIST OF PARTIES

1. The parties listed in the caption.

2. All American Services Co., Ltd., a Bermuda Corporation.

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## PETITION FOR A WRIT OF CERTIORARI

Petitioners, Edward C. Abell, Jr. ("Abell") and Carey Walton ("Walton"), individually and as representatives of the class of purchasers of Westside Habilitation Center Revenue Bonds ("Bonds"), pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered November 2, 1988.

## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit ("court of appeals"), (A-1),[1] is reported as *Abell v. Potomac Insurance Company*, 858 F.2d 1104 (5th Cir. 1988), *reh'g en banc denied*, ___ F.2d ___ (Dec. 1988). The district court opinion denying defendants' post-trial motions, (A-102), is reported as *Abell v. Potomac Insurance Company*, 1988 [CCH] Fed. Sec. L. Rep. ¶ 93648 (W.D. La. 1988).

## JURISDICTIONAL GROUNDS

The judgment of the court of appeals was entered on November 2, 1988 (A-128), and rehearing was denied on December 14, 1988 (A-130). This petition for a writ of certiorari was filed within 90 days of December 14, 1988, as required by 28 U.S.C. § 2101(c) and Rule 20 of the

[1] References to "A-___" are to the Appendix submitted with this Petition.

Supreme Court Rules. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

## STATUTORY PROVISIONS

The following statutes, regulations, and rules, set forth in the Appendix commencing at page A-173, are involved in this case:

Securities Exchange Act of 1934, §10(b), 15 U.S.C. § 78j;

17 C.F.R. 240.10b-5; and

Federal Rule of Civil Procedure 23.

## STATEMENT OF THE CASE

### 1. Preliminary Statement.

This case concerns the circumstances under which underwriter's counsel in a public securities offering may be held liable to investors under §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. It also involves the denial of presumptions of reliance that were recognized by this Court in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 92 S. Ct. 1456 (1972) and *Basic Inc. v. Levinson*, ___ U.S. ___, 108 S. Ct. 978 (1988), in a manner that raises conflicts with this Court and among the courts of appeals.

The case arises from a public issuance of $13,550,000 tax-exempt revenue bonds that subsequently defaulted. Following a nine week trial, a jury returned a verdict for the plaintiff class on all counts. The trial court entered

judgment[2] and denied the defendants' post-trial motions in a lengthy opinion[3] which thoroughly reviewed the evidence. The court of appeals reversed the judgment in part, holding that underwriters' counsel and its insurer were absolved of liability and denying the plaintiff class' claims under §10(b) because of a failure to prove individual reliance of the class members.

## 2. Background.

Joe E. Fryar ("Fryar") and All American Services Co., Ltd. ("AA"), a Bermuda corporation organized and controlled by Fryar, embarked on a scheme to defraud bondholders. The defendants formed an allegedly non-profit corporation, Westside Habilitation Center, Inc. ("Westside"), to own and operate a home for the mentally retarded in Cheneyville, Louisiana. Fryar, with the assistance of AA and the law firm of Wright, Lindsey & Jennings ("WLJ"), caused Westside to issue bonds to the public and used the proceeds to finance the acquisition and construction of the facility at grossly inflated prices for the enrichment of the defendants.

Fryar obtained certification from the State of Louisiana and purchased the property upon which the facility would be built ("the Cheneyville Property") for $100,000, its appraised value.[4] Fryar then incorporated Westside,

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[2] A-132.

[3] A-102.

[4] Fryar completely controlled Westside, making all its decisions, including the purchase price for the Cheneyville Property and the amount of his fees.

which had no capital assets at its inception. Westside initially planned to sell bonds to obtain revenues and assets. Thereafter, revenues paid by the State of Louisiana Medicaid program would be used to retire the bonds.

When Fryar was unable to obtain conventional financing, he turned to the possibility of financing through tax-exempt bonds. After unsuccessfully seeking bond financing through state authorities, Fryar convinced the Town of Cheneyville to approve a bond issuance by Westside.[5]

To facilitate the marketing of tax-exempt bonds, Fryar hired Booz, Allen & Hamilton, Inc. ("Booz Allen"), a nationally known consulting firm with extensive experience in evaluating health care facilities, to determine the feasibility of the project. Booz Allen concluded that Westside was not financially feasible and so stated in a July 23, 1979 report, noting several areas of concern. Despite subsequent consideration of possible solutions, Booz Allen never retracted its concerns regarding the financial structure of Westside. Undeterred, Fryar retained a firm with little experience in health care and with no knowledge of the medicaid program, from whom he obtained a favorable report.

In late 1981, Fryar "sold" the Cheneyville Property to AA, his Bermuda corporation, which then sold it to Westside for $2,459,700 -- $2,000,000 in Westside bonds and

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[5] The Town of Cheneyville actually approved a bond issuance in the lesser amount of $12,850,000 instead of the $13,500,000 actually issued; however, the Town's resolution subsequently and mysteriously was altered without permission of the Town, a fact admitted as material by WLJ.

the remainder in cash. AA pledged those bonds to secure Fryar's performance as developer. This transaction enabled Fryar to appear to have $2,000,000 of his *personal* funds at risk as security for the performance of his obligations, a fact expressly used to induce investors to purchase bonds. Furthermore, it concealed from investors the fact that Fryar realized an additional $2,000,000 and that the bondholders themselves were providing the security for Fryar's performance.

### 3. WLJ's Role.

WLJ assumed the role of underwriters' counsel in February, 1982, approximately two months before the bonds were issued. WLJ was retained after two other law firms withdrew. WLJ knew that the primary purpose of its engagement was to ensure adequate disclosure to investors, who were expected to rely upon such disclosure.[6]

WLJ, as underwriters' counsel, drafted, revised, and prepared in final form the offering documents, all of which bear its name, including the Summary Memorandum, Preliminary Official Statement ("POS") and the Final Official Statement ("OS"). WLJ made critical revisions to these documents, which served to conceal Fryar's ownership interest in the Cheneyville Property and his failure to have his own money at risk. Although well-established law and industry custom do not permit underwriters' counsel to rely solely on its client for the

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[6] A-136.

facts used in the offering documents,[7] WLJ failed to question anyone regarding the Westside transaction other than the underwriter that structured the transaction. WLJ knew this underwriter was the subject of investigations by the SEC, NASD and the FBI.

The offering documents prepared by and bearing the name of WLJ, as well as the sales circulars and oral representations derived from WLJ's offering documents, omitted many material facts. As the court of appeals stated, the omissions included "any information about the Booz Allen report"; that "Fryar had once owned the land"; or "any of the details of the transaction between Fryar and AA."[8]

As is customary, the bonds had been marketed in advance and were sold quickly after the April 26, 1982 closing. The bonds thereafter traded in the secondary market, with sales being effected by major brokerage firms, firms specializing in municipal bonds, and one of the original underwriters. Offers for purchases of the bonds were published in "The Blue List of Current Municipal and Corporate Offerings," a daily industry newsletter published by a division of Standard & Poor's Corporation, listing prices for bonds offered for resale in

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[7] *S.E.C. v. Frank*, 388 F.2d 486, 489 (2d Cir. 1968); *see also Escott v. Barchris Construction Corp.*, 283 F. Supp. 643, 690-92 (S.D.N.Y. 1968).

[8] A-10.

the secondary market[9]. Walton purchased in the primary offering in April, 1982, and Abell purchased in the secondary market three months later. A majority of the class members, likewise, purchased in the secondary market from brokerage firms other than the original underwriters.[10]

As predicted by Booz Allen in its undisclosed feasibility study, Westside could not pay the bondholders the interest due, defaulting on its obligations to pay interest on October 1, 1984.

**4. Proceedings Below.**

Abell and Walton, individually and on behalf of the class of purchasers, commenced this action for violations of federal and state securities laws, state law fraud, and the Racketeer Influenced and Corrupt Organizations Act. Jurisdiction was based on 28 U.S.C. § 1331. The district court certified the class despite objections based on the purported predominance of individual issues of reliance. Thereafter, the trial judge on several occasions rejected arguments that the individual reliance of each class member must be proven and refused to decertify the class. Relying upon the trial court's decisions that plaintiffs were entitled to a presumption of reliance, the bondholders purposefully omitted proof of individual reliance by each of the 500 class members. The jury returned a verdict in favor of the bondholders on all counts, and the court entered judgment upon that verdict, stating, "[t]he

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[9] A-140-41.

[10] (Pl. 313).

evidence adduced at trial convinces this court beyond any doubt that the jury's verdict is reasonable. Indeed, it defies logic to suggest that, given the evidence, the verdict is not completely meritorious."[11]

The court of appeals reversed the judgment in favor of the class on its §10(b) claims, holding that the bondholders were not entitled to the *Affiliated Ute* presumption of reliance available in omissions cases. Although the offering documents omitted any information about the Booz Allen report, the details of the land transaction, and other material facts, the court reasoned that the defendants said *something* about the offering, albeit incomplete, making the claim a misrepresentation claim. In the view of the court, the existence of affirmative misrepresentations along with omissions prevented the use of the presumption. The court of appeals further reasoned that the fraud-on-the-market theory of reliance is applicable where newly issued securities are involved only where the promoters intend a complete hoax or sham transaction, resulting in a patently worthless enterprise. The appellate court rendered judgment on the class' §10(b) claims without remanding for proof of individual reliance.

The court of appeals also reversed the judgment on the §10(b) claim against WLJ and its insurer. Although WLJ assumed the role of ensuring adequate disclosure of material facts to the public, knew the primary purpose of its role was to protect the bondholders who were expected to rely upon WLJ's actions, drafted and

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[11] A-127.

reviewed the offering documents, and allowed the publication of its name as the party charged with ensuring the adequacy of disclosure, the court of appeals held that WLJ owed no duty to disclose material facts in the offering documents. The court also overturned the jury verdict finding WLJ liable as an aider or abettor, holding that proof of recklessness is insufficient to satisfy the scienter requirement for an aiding and abetting violation absent a duty to disclose or evidence that the transaction lacks business justification.

## REASONS FOR GRANTING THE WRIT

### 1. The Decision That An Attorney Engaged To Prepare The Offering Documents And Ensure Adequate Disclosure In A Public Securities Offering Owes No Duty To Investors Conflicts With Decisions Of Other Courts Of Appeals And District Courts, And Involves An Unsettled Question Of Federal Law.

Courts, commentators, and the Securities and Exchange Commission long have recognized the critical role of securities lawyers in protecting the public from securities fraud.[12] Several courts of appeals have held that attorneys, including underwriter's counsel, owe a duty of disclosure to investors under §10(b). In *Cronin v. Midwestern Oklahoma Development Authority*, 619 F.2d 856,

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[12] *S.E.C. v. Spectrum Ltd.*, 489 F.2d 535, 536 (2d Cir. 1973) (effective implementation of securities laws "depends in large measure on the members of the bar who serve in an advisory capacity to those engaged in securities transactions"); Exchange Act Release No. 17831, 1981 [CCH] Fed. Sec. L. Rep. ¶ 82,874 (June, 1981).

862 (10th Cir. 1980), the Tenth Circuit recognized that counsel which participate in issuance of bonds owe a duty to the buyers to reveal the facts. The Second Circuit recognized the duty of attorneys to investors in holding an attorney who failed to correct a misleading prospectus liable under §10(b). *S.E.C. v. Manor Nursing Center, Inc.*, 458 F.2d 1082, 1095 (2d Cir. 1972). Similarly, in *DCD Programs, Ltd. v. Leighton*, 833 F.2d 183, 190 (9th Cir. 1987), the Ninth Circuit held that a law firm has a duty to disclose where there is a fiduciary relationship, knowledge of insider information, or knowing participation in a fraudulent scheme. Numerous district court decisions recognize the securities lawyer's duty to investors.[13] The courts generally reason that attorneys involved in the drafting of offering documents can reasonably foresee that investors will rely on their actions.[14] The securities industry itself recognizes that attorneys participating in

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[13] *Seidel v. Public Service Co. of New Hampshire*, 616 F. Supp. 1342, 1362 (D.N.H. 1985); *Ahern v. Gaussion*, 611 F. Supp. 1465, 1488-89 (D. Ore. 1985); *In re Flight Transportation Corp. Sec. Litigation*, 593 F. Supp. 612, 617-18 (D. Minn. 1984); *Morgan v. Prudential Group, Inc.*, 527 F. Supp. 957, 960-61 (S.D.N.Y. 1981), *aff'd without opinion*, 729 F.2d 1443 (2d Cir. 1983); *Schaps v. R.A. Transportation*, 1987 U.S. Distr. Lexis 4756 (E.D. Ill. 1987).

[14] *See e.g., S.E.C. v. Manor Nursing Center, Inc.*, 458 F.2d 1082, 1096-97 (2d Cir. 1972); *Morgan v. Prudential Group, Inc.*, 527 F. Supp. 957, 960-61 (S.D.N.Y.), *aff'd without opinion*, 729 F.2d 1443 (2d Cir. 1983); *In re North American Acceptance Corp.*, 1981 [CCH] Fed. Sec. L. Rep. ¶ 98,258 (N.D. Ga. 1981). *Cf. Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 653 (9th Cir. 1988) (accounting firm).

securities transactions owe a duty to the investing public.[15] WLJ's David Menz admitted that the purpose in ensuring complete disclosure is to protect the bondholders. Mr. Menz testified:

> Q. And the purpose of requiring adequate disclosure is to protect the bondholders? That's the principal purpose of it, is it not?
>
> A. Right.
>
> * * *
>
> Q. But you had an obligation as underwriter's counsel to make sure what was communicated to the bondholders was truthful in all respects, isn't that right?
>
> A. Certainly.[16]

Ignoring WLJ's admission, the custom and practice of the securities industry and the above-cited authorities, the court of appeals held that WLJ owed no duty to the bondholders simply because it did not sign the offering documents which bear its name and approval. This decision alone holds that lawyers who prepare and

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[15] James Perkins, immediate past president of the National Association of Bond Lawyers, testified: "The standard is grounded in the need to protect their clients and themselves from liability and to *protect the public insofar as it's their* (underwriter's counsel) *responsibility to protect the public from being taken in.* . . . there would be no doubt in my mind as to the understanding of law firms and securities underwriters across the country that the law firm listed as underwriter's counsel is expected, on behalf of the underwriters, to meet the so-called due diligence responsibility." Tr. V. 83, pp. 55-56. (Emphasis added).

[16] Tr. V. 81, pp. 13-14; 140.

review offering documents for potential investors with the expectation that such investors will rely upon their actions owe no duty to the public.[17]

In reaching its decision, the court below relied heavily on the Seventh Circuit's decision in *Barker v. Henderson, Franklin, Starns & Holt*, 797 F.2d 490 (7th Cir. 1986). *Barker* is inapposite. There, the court held that a law firm that did not participate in preparing the offering documents, did not see them during the relevant period, and did not permit its name to be used on them, did not owe a duty to "tattle" on the client when it subsequently discovered the fraud. In contrast, here, the issue is whether an attorney which participated in preparing the offering documents, approved them and affixed its name to them, with the expectation that the investing public would rely on its actions, owed a duty to disclose material facts to investors.[18]

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[17] None of the decisions cited by the court of appeals hold that a duty arises only where the attorney renders a written legal opinion. Rather, the finding of no duty in the cited cases rested upon a determination that the attorney could not foresee reliance. The cited cases, in fact, stand for the proposition that where reliance is foreseen, a duty is imposed. *See, e.g., Bush v. Rewald*, 619 F. Supp. 585, 598 (D. Haw. 1985). Moreover, the decisions cited by the court did not involve attorneys who participated in drafting offering documents.

[18] The court of appeals also reasoned that imposing a duty of disclosure on attorneys participating in securities transactions somehow conflicts with an attorney's ethical obligations to its clients (A-41-42). To the contrary, the SEC has fashioned rules requiring attorneys in such a situation to either disclose the facts or withdraw under certain circumstances from the engagement. *In re Carter*, 1981 [CCH] Fed. Sec. L. Rep. ¶ 82,847 at p. 84,172; SEC Release No. 34-17547 (Feb. 1981). This rule is in accordance with the testimony of James Perkins, the plaintiffs' expert.

This unprecedented decision should be reviewed to correct the conflict with decisions of other courts. If not reviewed, the decision will enable attorneys who intentionally or recklessly disregard their responsibilities to escape liability simply by not signing the offering documents. As noted by the Securities and Exchange Commission, such artificial distinctions should not be relied upon in determining liability under the securities laws:

> Liability in these circumstances should not turn on such artificial distinctions, particularly in light of the almost limitless range of forms which legal advice may take. Moreover, the opposite approach, which would permit a lawyer to avoid or reduce his liability simply by avoiding participation in the drafting process, may well have the undesirable effect of reducing the quality of the disclosure by the many to protect against the defalcations of the few. *In re Carter*, 1981 [CCH] Fed. Sec. L. Rep. ¶ 82,847 at p. 84,172; SEC Release No. 34-17547 (Feb. 1981).

Furthermore, the court's error in holding that attorneys owe no duty to investors is compounded by its decision that, absent such duty, a clear proof of intent rather than recklessness is required to satisfy the scienter requirement for an aiding and abetting violation.[19] The decision means that attorneys involved in public offerings of securities can avoid liability under §10(b) unless plaintiffs can establish a clear proof of intent to violate the securities laws, a difficult, if not impossible task.

In contrast to this decision, other courts of appeals have held that recklessness will satisfy the scienter requirement where it is reasonably foreseeable that

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[19] A-47-51.

potential investors will rely upon the aider and abettor's actions.[20] District courts are in agreement.[21] The SEC, likewise, has implied that recklessness is the appropriate standard.[22]

Absent review, severely reckless conduct of securities attorneys who substantially assist in the commission of securities fraud will be condoned. This result is at odds with the traditional role of securities lawyers to ensure compliance with the securities laws and protect investors.

### 2. The Decision That The Plaintiff Class Was Not Entitled To Either The "Affiliated Ute" Or The Fraud-On-The-Market Presumption Of Reliance Conflicts With This Court's Decisions And Decisions Of Other Courts Of Appeals.

The court below held that the plaintiff class was not entitled to a presumption of reliance under *Affiliated Ute* or under the fraud-on-the-market theory. The decision conflicts with this Court's decisions and decisions of

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[20] *S.E.C. v. Seaboard Corp.*, 677 F.2d 1301, 1312 (9th Cir. 1982) ("An accountant may be liable as an aider and abettor if it knows, or is reckless in not knowing, that its client has committed a primary violation, and it substantially aids the client in the overall enterprise"); *Morgan v. Prudential Group, Inc.*, 527 F. Supp. 957, 961 (S.D.N.Y. 1981), (where the foreseeability of reliance is apparent the recklessness standard may be applied to hold an attorney liable as aider or abettor), *aff'd without opinion*, 729 F.2d 1443 (2d Cir. 1983).

[21] *S.E.C. v. Electronics Warehouse, Inc.*, 689 F. Supp. 53, 60 (D. Conn. 1988); *In re Storage Technology Corp. Securities Litigation*, 630 F. Supp. 1072, 1076 (E.D. Colo. 1986).

[22] *In re Carter*, 1981 [CCH] Fed. Sec. L. Rep. ¶ 82,847 at 84,167, Release No. 34-17547 (Feb. 1981).

other courts of appeals. Furthermore, the decision destroys the utility of the class action device in securities fraud litigation.

**A. The Ute Presumption.**

The court of appeals held that the class was not entitled to the presumption of reliance afforded plaintiffs claiming failure to disclose material facts pursuant to *Affiliated Ute v. United States*, 406 U.S. 128, 92 S. Ct. 1456 (1972), because plaintiffs' claims involved distortions or half truths, rather than pure omissions.[23] In conflict with *Affiliated Ute* and its progeny, the court of appeals essentially held that the *Ute* presumption applies only in cases involving *pure* nondisclosures. It determined that the plaintiff class was not entitled to the *Ute* presumption, despite acknowledging that the offering documents "did not contain any information about the Booz Allen report" or "any of the details of the land transactions between Fryar and AA".[24] The court of appeals cast plaintiffs' claims as misrepresentations simply because the defendants said *something*, despite the fact that what was said omitted material facts, and denied plaintiffs the presumption afforded by the *Ute* theory.[25]

In refusing to apply the *Ute* presumption, the court of appeals did not overrule the trial court's decision that

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[23] A-29.

[24] A-10.

[25] The Eleventh Circuit also has held that the *Ute* presumption only applies in pure omissions cases. *Cavalier Carpets, Inc. v. Caylor*, 746 F.2d 749, 757 (11th Cir. 1984).

this is "an omission action."[26] Instead, it interpreted the decisions applying *Ute* to conclude that the presumption generally is unavailable when the fraud consists of a mixture of omissions and misrepresentations.[27] The court determined that, for the presumption to apply, the plaintiff's focus must be that "the defendant has failed to disclose any information whatsoever relating to material facts about which the defendant has a duty to the plaintiff to disclose".[28] Further, it determined that the presumption is inapplicable where the plaintiff alleges the defendant "has distorted the truth by making false but misleading incomplete statements."[29] In effect, the court determined that a plaintiff cannot qualify for the *Ute* presumption, even if omissions are the most important part of the fraud, if *any* affirmative statements are made – since the affirmative disclosures are always "misleading incomplete statements."

The decision runs counter to this Court's ruling in *Affiliated Ute* and to decisions of other courts of appeals applying *Affiliated Ute*. In *Affiliated Ute*, the defendant bank employees misrepresented the prevailing market price of securities *and* failed to disclose that defendants expected to personally benefit from sales of plaintiffs' stock. Although defendants had misrepresented certain material facts, this Court held that "[u]nder the circumstances of this case, involving primarily a failure to disclose, [the plaintiffs were not required to offer] positive

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[26] A-108.

[27] A-29.

[28] *Id.* at A-29.

[29] *Id.* at A-29.

proof of reliance . . . [as] a prerequisite to recovery." *Ute* thus stands for the proposition that a presumption of reliance is to be afforded plaintiffs in cases involving *primarily* a failure to disclose, regardless of whether misrepresentations also are made. The case need not be a pure case of nondisclosure.

Consistent with *Affiliated Ute*, three courts of appeals have held that availability of the *Ute* presumption is not limited to cases of pure nondisclosure. Rather, plaintiffs are entitled to the presumption of reliance where omissions of material fact are alleged, notwithstanding that defendants also may have misrepresented material facts. In *Harris v. Union Electric Co.*, 787 F.2d 355 (8th Cir.), *cert. denied*, 479 U.S. 823, 107 S. Ct. 94 (1986) the Eighth Circuit held that the class of bondholders which claimed, among other things, that "the prospectus for the . . . Bonds misrepresented and omitted material facts regarding the call-protection provisions of the bond contract," were entitled to a presumption of reliance because the case consisted primarily of allegations of a failure to disclose.[30] Similarly, the Third Circuit in *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 189 (3rd Cir. 1981), *cert. denied*, 455 U.S. 938, 102 S. Ct. 1427 (1982) held that the burden of proof regarding the reliance issue should fall upon the defendant where both misrepresentations and omissions are alleged, stating "defendant's misrepresentation of other facts should not alleviate its burden of proving nonreliance". And, the Ninth Circuit in *Cameron v. E.M.*

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[30] *Accord Barnes v. Resource Royalties*, 795 F.2d 1359, 1367 (8th Cir. 1986); *Austin v. Loftsgaarden*, 675 F.2d 168, 177 (8th Cir. 1982).

*Adams & Co.*, 547 F.2d 473, 477 (9th Cir. 1976) held individual reliance is not a required element of proof for a plaintiff class alleging factual omissions and misrepresentations.[31] Numerous district courts likewise have held plaintiffs entitled to the *Ute* presumption of reliance where both misrepresentations and omissions were alleged.[32] Indeed, the trial judge here found that the defendants' contention regarding lack of reliance was "specious and . . . unfounded in the law."[33]

The decision destroys the *Ute* presumption in cases where disclosure documents exist unless absolutely nothing is said in the documents.[34] If potential violators reveal "something," no matter how false or misleading, they may avoid the *Ute* presumption and liability under §10(b). This ruling stands logic on its head.

### B. The Fraud-On-The-Market Theory.

The court of appeals also held that the class was not entitled to a presumption of reliance under the fraud-on-the-market theory. The decision conflicts with this

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[31] *Accord Blackie v. Barrack*, 524 F.2d 891, 905-906 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S. Ct. 57 (1976).

[32] *Jackson v. First Federal Savings of Arkansas, F.A.*, 1989 [CCH] Fed. Sec. L. Rep. ¶ 94,123 (E.D. Ark. 1988); *Dekro v. Stern Bros.*, 540 F. Supp. 406 (W.D. Mo. 1982); *Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730 (W.D. Va. 1982).

[33] A-108.

[34] Indeed, the Fifth Circuit previously recognized that *Affiliated Ute* was "primarily" a case of nondisclosure rather than one of "pure nondisclosure." *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 363 (5th Cir. 1987), *cert. denied*, 108 S. Ct. 1220 (1988). This case contradicts that ruling.

Court's decision in *Basic Inc. v. Levinson*, ___ U.S. ___, 108 S.Ct. 978 (1988), and decisions of other courts of appeals.

In *Basic*, the Court recognized a presumption of reliance where defendants made material misrepresentations and sold securities in an impersonal, efficient market. The presumption recognized in *Basic* is founded upon the notion that "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." *Id.* at 991-92. Courts of appeals and district courts which have considered the issue have extended the fraud-on-the-market theory to newly issued securities where it is established that, absent the fraud, the securities could not have been marketed. *See e.g., Ross v. Bank South, N.A.*, 837 F.2d 980 (11th Cir.) *reh'g en banc granted*, 848 F.2d 1132 (1988); *Goldwater v. Alston & Bird*, 664 F. Supp. 403, 410 (S.D. Ill. 1986). In the context of newly issued securities, the theory is not based upon a relation between the fraud and the market *price*, but upon the notion that an issuance may be so tainted with fraud that it otherwise could not have been marketed.

**(i) The Decision Below Imposes An Unprecedented Insurmountable Burden Of Proof For Newly Issued Securities.**

The court of appeals severely limited applicability of the fraud-on-the-market theory in cases involving newly issued securities by requiring proof that "the promoters knew the enterprise itself was patently worthless."[35] The restriction adopted by the Fifth Circuit is unprecedented. Nearly every court that has considered the fraud-on-the-market theory as applied to revenue or other types of

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[35] A-35-36.

bonds or newly issued securities has concluded that the theory is applicable without this insurmountable burden of proof. These courts almost universally have held that plaintiff need only prove that, absent the fraud, the securities could not have been marketed. As noted in *Ross v. Bank South, N.A.*, 837 F.2d 980, 994, 1002 (11th Cir. 1988), *reh'g en banc granted*, 848 F.2d 1132 (1988), a *prima facie* case showing reliance is established in new issuance cases by proving that "[b]ut for the fraud . . . plaintiff *could not* have purchased the bond because the bonds would not have been offered for sale." (Emphasis in original).

The Eleventh Circuit has held the fraud-on-the-market theory applicable in a class action arising out of the issuance and sale of limited partnership interests in oil and natural gas investment funds concededly not traded on a public exchange upon proof that the securities could not have been marketed absent the fraud. *Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718, 723 (11th Cir. 1987), *cert. denied*, ___ U.S. ___, 108 S. Ct. 1220 (1988).[36] Similarly, in

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[36] The Eleventh Circuit expressly approved the application of the fraud-on-the-market theory to industrial bonds upon proof that the bonds could not have been marketed but for the fraud in *Shores v. Sklar*, 844 F.2d 1485 (11th Cir.), *reh'g en banc granted*, 855 F.2d 722 (1988) and *Ross v. Bank South, N.A.*, 837 F.2d 980 (11th Cir. 1988). The decisions subsequently were vacated and rehearing *en banc* granted. *Ross v. Bank South, N.A.*, 848 F.2d 1132 (11th Cir. June, 1988). Oral argument was heard in October. The Securities and Exchange Commission filed an amicus brief urging that the court uphold the principle that purchasers may rely on the market to support the issuance only of marketable securities. A copy of that brief is included in the Appendix beginning at A-144.

*T.J. Raney & Sons v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330, 1333 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026, 104 S. Ct. 1285 (1984), the Tenth Circuit held that the plaintiff class of industrial revenue bond purchasers stated claims under Rule 10b-5 "by alleging that the defendants knowingly conspired to bring unlawfully issued . . . bonds to market with the intent to defraud, that it reasonably relied on the availability of the bonds as indicating their lawful issuance, and that it suffered injury resulting from the purchase of the bonds."

Likewise, the Ninth Circuit has held that a presumption of reliance applied in a class action brought by purchasers of an original issue of securities. *Arthur Young & Co. v. U.S.D.C.*, 549 F.2d 686, 695 (9th Cir.), *cert. denied*, 434 U.S. 829, 98 S. Ct. 109 (1977). Numerous district courts are in accord that the fraud-on-the-market theory is applicable to initial public offerings of bonds or stocks upon proof that the securities would not have been marketed but for the fraud.[37] These decisions establish that the jurisprudence simply has not imposed a requirement of demonstrating total worthlessness. *See, e.g., Jackson v. First Federal Savings of Arkansas, F.A.*, 1989 [CCH] Fed. Sec. L. Rep. ¶ 94,123 (E.D. Ark. 1988).

In conflict with these decisions, the court imposed an insurmountable burden upon a plaintiff class in an action involving an initial public offering, requiring proof that

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[37] *Goldwater v. Alston & Bird*, 664 F. Supp. 403, 411 (S.D. Ill. 1986); *Rose v. Arkansas Valley Environmental & Utility Authority*, 562 F. Supp. 1180, 1201-03, 1206 (W.D. Mo. 1983); *Dekro v. Stern Bros. & Co.*, 540 F. Supp. 406, 413 (W.D. Mo. 1982).

the promoters knew the enterprise was patently worthless. This holding limits the scope of the fraud-on-the-market theory in the context of newly issued securities to complete sham transactions, "sale of the Brooklyn Bridge cases," because those are the only circumstances in which a plaintiff could satisfy the Fifth Circuit's standard. Indeed, under the strict standard imposed by the court of appeals, a promoter who is advised that his project is not feasible and that investors will recover only a fraction of their investment will not be subject to the fraud-on-the-market theory, provided he did not intend to abscond with *all* of the money. Such a result is surely inconsistent with the premise of the securities laws and the purpose of the fraud-on-the-market theory to afford a remedy to defrauded investors who cannot prove direct reliance.

In fact, the decision destroys the effectiveness of the class action device, the most cost-effective method of redressing the claims of a multitude of investors possessing related small losses.[38] As Professor Loss has observed, "[t]he ultimate effectiveness of the federal remedies . . . may depend in large measure on the applicability of the class action device". 3 Loss, *Securities Regulation* 1819 (2d ed. 1961). Because reliance is an essential

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[38] *Escott v. Barchris Construction Corp.*, 340 F.2d 731, 733 (2d Cir.), *cert. denied sub nom., Drexel & Co. v. Hall*, 382 U.S. 816, 86 S. Ct. 37 (1965); *see also Arthur Young & Co. v. U.S.D.C.*, 549 F.2d 686 (9th Cir.), *cert. denied*, 434 U.S. 829, 98 S. Ct. 109 (1977); *Esplin v. Hirschi*, 402 F.2d 94, 101 (10th Cir. 1968), *cert. denied*, 394 U.S. 928, 89 S. Ct. 1194 (1969).

element of a Rule 10b-5 action, *Basic Inc. v. Levinson*, ___ U.S. ___, 108 S.Ct. 978, 989 (1988), maintenance of a class action in securities fraud litigation often is dependent upon entitlement to a presumption of reliance. Since most class actions involve a large number of investors with related small losses, the reliance presumption is essential. Absent the presumption, proof of individual reliance by each class member would be too costly or difficult, resulting in potential claims remaining unprosecuted. The decision to deny the plaintiff class a presumption of reliance except in the most improbable of circumstances, therefore, will seriously impede the effectiveness of the remedial provisions of the securities laws and should be reviewed.

**(ii) Bonds Trade On An Active Impersonal Market.**

In recognizing the fraud-on-the-market theory in *Basic*, this Court did not distinguish between stocks, revenue or municipal bonds, or other types of securities, requiring only that the securities be traded on an "impersonal, efficient market" as opposed to face-to-face transactions. As this Court explained, such developed markets "differ from . . . face-to-face transactions," and the fraud-on-the-market reliance theory encompasses those differences. *Basic Inc. v. Levinson*, ___ U.S. ___, 108 S. Ct. 978, 989-90 (1988).

*Basic* thus stands for the proposition that the fraud-on-the-market theory applies to transactions in which a market is interposed between buyers and sellers, as opposed to face-to-face transactions between the parties. The Court in *Basic* did not require that the market be a

public exchange. Rather, an "impersonal, efficient" market is sufficient.

The *Basic* Court implicitly acknowledged that revenue bonds trade in such an impersonal, efficient market. It cited decisions involving revenue bonds in support of the proposition that plaintiffs are entitled to a presumption of reliance where materially misleading statements have been disseminated into such a market.[39]

Applying the principles enunciated in *Basic*, the court below should have affirmed the jury verdict and held positive proof of reliance was unnecessary under the fraud-on-the-market theory. Plaintiffs established by unrefuted evidence that the bonds were actively traded in an impersonal, efficient market through brokerage firms other than the original underwriters (Pl. 313). Indeed, Abell and the majority of the class members purchased in the secondary market during the period from April 20, 1982 through October 1, 1984. Moreover, expert testimony was elicited describing how prices are derived in the actual secondary market from "blue

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[39] *Id.* at 991, n.25. The decisions involving bonds relied upon are *Harris v. Union Electric Co.*, 787 F.2d 355, (8th Cir.), *cert. denied*, 479 U.S. 823, 107 S. Ct. 94 (1986) (plaintiff class comprised of holders of First Mortgage Bonds of Union Electric Company on a date three years after the initial issuance); and *T.J. Raney & Sons v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026, 104 S. Ct. 1285 (1984) (involving bonds issued by the Fort Cobb, Oklahoma Irrigation Fuel Authority).

lists"[40] which reflect the "offer side of the market," and that the Bonds continuously were offered in the blue list, which connotes trading in the secondary market. (A-140-43). The plaintiffs further established that defendants disseminated materially misleading statements into the market and that the Bonds could not have been marketed but for defendants' fraud.

The court nevertheless concluded that the fraud-on-the-market theory recognized in *Basic* was inapplicable because the Westside Bonds "were not actively traded on any exchange or in any large secondary market."[41] The court reached this conclusion despite the fact that the evidence established that the Bonds were actively traded in a secondary market as opposed to face-to-face transactions. Because the court below relied heavily upon *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102, 103 S. Ct. 722 (1983), without discussing the evidence in this case establishing substantial trading through brokerage firms subsequent to the initial issuance, the court seemingly held as a matter of law that such bonds do not trade in an impersonal, efficient market of the type referred to in *Basic*. The decision below therefore improperly restricts the applicability of the fraud-on-the-market theory of *Basic*, in effect, to securities traded on a public exchange. That restriction conflicts with *Basic* and decisions of other courts.

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[40] The "blue list" is a daily publication of a division of Standard & Poor's Corporation fully entitled "The Blue List of Current Municipal and Corporate Offerings".

[41] A-34.

This Court in *Basic* implicitly recognized the applicability of the fraud-on-the-market theory to bonds and other securities not trading on a public exchange. The Eighth Circuit expressly did so in *Harris v. Union Electric Co.*, 787 F.2d 355 (8th Cir.), *cert. denied*, 479 U.S. 823, 107 S.Ct. 94 (1986). There, the court expressly approved application of the fraud-on-the-market theory to newly issued corporate mortgage bonds in a class action. Finding that the plaintiffs proved that the prospectus increased the price of the bonds on the open market, which later purchasers relied upon, the court held reliance established. *Id.* at 367.

The decisions recognizing that bonds do trade in impersonal, efficient markets are correct. The Blue List has indicated daily offerings of bonds in an amount in excess of $1.8 billion. Such transactions are effected through brokerage firms nationwide who cite prices derived from the "blue list" published daily, not in face-to-face transactions. The bond market undoubtedly qualifies as "the impersonal, efficient market" described in *Basic*. The decision below suggesting to the contrary, therefore, should be reviewed.

## CONCLUSION

This case presents issues of substantial importance affecting the enforcement of the federal securities laws in conflict with decisions of this Court and for which a conflict among the circuit courts exists. A writ of certiorari should issue in order to review the decision below involving a securities attorney's duty to investors and the

availability of reliance presumptions in an action under §10(b) of the Securities Exchange Act of 1934.

Respectfully submitted,

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**v.**

**POTOMAC INSURANCE COMPANY, et al., Defendants,**

**Joe E. Fryar, Wright, Lindsey and Jennings, and Valley Forge Insurance Company, Defendants-Appellants Cross-Appellees.**

**No. 87-4260.**

United States Court of Appeals
Fifth Circuit.

Nov. 2, 1988.

Bond purchasers brought action against developer whose company issued the bonds, bond counsel, and others. The United States District Court for the Western District of Louisiana, John M. Shaw, J., entered judgment on jury verdict in favor of plaintiffs on all claims, and defendants appealed. The Court of Appeals, Jerry E. Smith, Circuit Judge, held that: (1) bond counsel and person whose corporation issued the bonds were not "sellers" for purposes of the Securities Act or the Louisiana Blue Sky Law; (2) statements were shown to be material; (3) plaintiffs could not use *Ute* presumption or fraud on the market theory to show reliance by class; (4) plaintiffs did not show any reliance on statements made by bond counsel; (5) bond counsel could not be held liable on breach of fiduciary duty or other theories with respect to nonclients; (6) attorneys were not vicariously liable; (7) plaintiffs established RICO violation by developer whose corporation issued the bonds; (8) plaintiffs

were not limited to out-of-pocket damages; and (9) developer did not show that he was prejudiced by jury's knowledge of his attempt to bribe one juror.

Affirmed in part, reversed in part, and remanded.

Appeal from the United District Court for the Western District of Louisiana.

Before THORNBERRY, WILLIAMS, and SMITH, Circuit Judges.

JERRY E. SMITH, Circuit Judge:

This is a civil case involving securities fraud, racketeering, and pendent state law claims. The plaintiffs, a class of investors who own bonds issued by the Westside Rehabilitation Center ("Westside"), allege that Joe Fryar, Westside's developer, and Wright, Lindsey & Jennings ("WLJ"), a Little Rock, Arkansas, law firm representing the bond issue's underwriters, fraudulently caused Westside to default on its bond interest payments, ultimately causing the bondholders to lose millions of dollars. After a two-month trial, the jury returned a multi-million-dollar verdict in favor of the plaintiffs and against Fryar, WLJ, and their two co-defendants, All American Services, Inc. ("All American"), and Valley Forge Insurance Company ("Valley Forge"). The district court, which rejected all of the defendants' motions for judgment notwithstanding the verdict, entered judgment upon this verdict and awarded plaintiffs damages totaling approximately $15 million. All of the defendants appealed from this judgment, but we dismissed All American's appeal for failure to prosecute. We now reverse and render the judgment against WLJ and Valley Forge, and affirm in

part the judgment of liability against Fryar, and remand for redetermination of damages, interest, and attorneys' fees.

## I. *Facts as to the Merits.*[1]

Westside, a non-profit corporation based in Cheneyville, Louisiana, was masterminded by its developer, Joe Fryar. Fryar originally conceived of Westside as a home for the mentally retarded, but he eventually changed Westside's targeted clientele to severely mentally and emotionally-disturbed patients. Fryar then prepared to translate his ideas into reality.

First, Fryar purchased 6.47 acres of land and a thirty-year-old vacant school building in Cheneyville (the "Cheneyville property") from the Rapides Parish School Board on January 3, 1978, for the sum of $100,000, its appraised value. Fryar then incorporated Westside in 1979. At its inception, Westside had no capital assets; rather, its sole source of revenue and assets initially was to be the sale of bonds. Thereafter, Westside would rely on revenues paid by the State of Louisiana Medicaid program, which revenues would be used to retire the bonds.

Fryar hired his attorney, William Skye, to prepare the incorporation papers. Although a five-member board of directors was appointed, the board never collectively made any decisions on behalf of Westside. Rather, Fryar

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1. We recite the facts of this case in the light most favorable to the jury's verdict.

continued to control Westside and make all its decisions, including the purchase price for the Cheneyville property and the fees to be paid Fryar. Throughout the period relevant to this appeal, Fryar continued to run Westside.

Fryar's initial problems involved obtaining a certificate of need for Westside[2] and the capital funds necessary to launch the project. Ultimately, Westside succeeded in obtaining its certificate of need, despite some opposition from officials in the Louisiana Department of Health and Human Resources. Fryar, however, found it considerably more difficult to procure capital funding for Westside.

Fryar knew that building the Westside facility and starting up its operations would cost millions of dollars. To raise the needed capital, he decided to market bonds. Initially, Fryar hired the nationally-known financial feasibility firm of Booz, Allen & Hamilton, Inc. ("Booz, Allen"), to evaluate the Westside project.

Booz, Allen dealt the Westside project its first blow. In a report dated July 23, 1979, the firm concluded that Westside was not financially feasible. Booz, Allen found several areas of concern, including (1) the possibility that the state medicaid program would impose ceilings on medicaid reimbursement; (2) the difficulties Westside would encounter in retiring its debt, since it depended

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2. Medical facilities that receive Medicaid reimbursements must have a certificate of need. Since Westside was designed to rely upon Medicaid as its only source of funding, Westside's existence depended upon Fryar's ability to obtain that certificate.

entirely upon medicaid reimbursements and lacked adequate sources of working capital; and (3) the inherent faults of the Westside concept in a state whose prevailing policies required placing Westside's potential patients in group homes.

The study caused Fryar to change his targeted clientele to emotionally-disturbed and mentally-retarded patients, but even this change did not alter Booz, Allen's decision. After Fryar threatened Booz, Allen with suit because of its adverse conclusions, Booz, Allen agreed to sign a letter drafted by WLJ's predecessor as bond counsel, the Boston law firm of Mintz, Levin, Cohn, Ferris, Glovsky & Popeo ("Mintz, Levin"). That epistle noted only the change in clientele and stated that Booz, Allen's conclusions may not necessarily still be applicable. The letter from Booz, Allen did not solve Fryar's problems, because he still did not have a favorable feasibility study.

Undeterred, Fryar retained Real Estate Research Corporation ("RERC"), experienced primarily in appraising real estate, to conduct a feasibility study. RERC ultimately delivered a favorable report. Meanwhile, Fryar encountered other difficulties in effecting a bond issue to fund Westside. He initially asked the Louisiana State Bond Commission for permission to finance the project through the Louisiana Public Facilities Authority; citing a variety of concerns, the Commission declined to approve financing for Westside bonds. Shortly thereafter, Westside's bond counsel, the New York law firm of Mudge, Rose, Guthrie & Alexander, resigned. Some time later, Westside retained John W. Peck of Peck, Shaffer & Williams as the new bond counsel.

Ultimately, Fryar convinced the Town of Cheneyville to back a $12,850,000 municipal bond issue. Later, and somewhat mysteriously, the bond authorization was increased to $13,550,000. Having described Fryar's long and successful struggle to obtain backing for the bond issue, we turn to how Fryar arranged Westside's finances.

Fryar had determined that he needed to receive over $5,000,000 to renovate, construct, and operate the Westside facility for an estimated seven months until it became self-sufficient. Westside's final offering statement for the bonds indicates that Westside also planned to expend over $3,200,000 in interest payments on the bonds, over $2,100,000 for debt service, more than $1,000,000 as an underwriter's discount, and $2,459,700 for "acquisition of center." The offering statement does not reveal in explicit detail how Westside actually acquired its facilities, and the failure of the offering statement to explain that transaction more thoroughly is at the heart of this multi-million-dollar litigation.

Fryar planned to issue the revenue bonds in the following denominations and maturities:

| Interest Rate | No. of Bonds | Face Amount | Total Amount | Due Date |
|---|---|---|---|---|
| 16.50% | 7,790 | $5,000 | $ 8,950,000 | Oct. 1, 2013 |
| 16.25% | 80 | 5,000 | 400,000 | Oct. 1, 2002 |
| 16.00% | 40 | 5,000 | 200,000 | Oct. 1, 1998 |
| 14.00% | 800 | 5,000 | 4,000,000 | Oct. 1, 2013 |
| | 2,710 | | $13,550,000 | |

Until late 1981, Fryar owned the property eventually used to establish Westside. In 1981, he either contacted or helped create All American, a Bermuda corporation. Frequently using the mails and the wires to communicate messages and transmit documents, Fryar and All American eventually devised a complicated transaction to dispose of Fryar's interest in the land. Fryar, who had bought the land in 1978 for $100,000, agreed to sell this land to All American for $150,000. All American then sold the land to Westside for $2,479,000 – $2,000,000 in Westside bonds and the remainder in cash. All American, retaining its ownership interest in the bonds, allowed Fryar to pledge those bonds to secure Fryar's performance of his duties as the developer of the project.

This transaction accomplished several things for Fryar and All American. First, it allowed Fryar to make a 50-percent up-front profit from owning the land for only three years. Second, it produced a profit for All American of over $2,300,000 – a profit which by itself was over 15 times what All American had originally paid. Third, it allowed All American to enjoy the benefits of owning $2,000,000 worth of tax-exempt municipal bonds, including the interest payments periodically due on those bonds. Finally, it allowed Fryar to claim that he had pledged over $2,000,000 of bonds to the completion of the Westside project and thus to imply that he had over $2,000,000 of his own money at risk in the project.

At this point, Fryar began to rely upon the professionals preparing the Westside bonds for market. Those professionals included Joseph Hancock and his underwriting firm, Hancock, Joseph & Daniels; Skye, Westside's attorney; Peck, whose firm of Peck, Shaffer &

Williams continued to serve as bond counsel; Robert Sheddy of Swink & Co., the other underwriter for the bond issue; and Mintz, Levin, then counsel for the two underwriters. Just before Westside's scheduled closing and issuance of the bonds, Mintz, Levin resigned as underwriter's counsel, purportedly because the associate working on the Westside bond offering left Mintz, Levin to join another law firm. When that associate departed in February 1982, there were only a few weeks left until Westside was scheduled to close its bond deal with the underwriters.

Under these circumstances, the underwriters immediately hired WLJ as their counsel. WLJ at once launched into preparing the bond offering to satisfy the securities laws of two dozen or more states. At the same time, WLJ assumed strict "due diligence" duties. WLJ was responsible (to its clients, at least) for carefully reviewing the final offering statement and for interviewing all the key participants to the bond transaction and those people necessary to the success of the Westside project. According to the expert testimony of James Perkins, an experienced securities lawyer from Boston, WLJ failed seriously in its due diligence duties to investigate the bond transaction, and thus failed to uncover the details of the Cheneyville land transaction and some of the details of Westside's history.

The offering statement, which the underwriters (WLJ's new clients) prepared, contained many of the relevant facts bearing on the Westside project. However, the offering statement did not reveal everything we now

know. For instance, the final offering statement did not contain any information about the Booz, Allen report.[3] Moreover, the final offering statement reported that All American had sold the Cheneyville land to Westside for $2,479,000, but it did not add that Fryar had once owned the land, nor did it report any of the details of the transaction between Fryar and All American. Finally, the offering statement reported flatly that Fryar had pledged $2,000,000 of Westside bonds to the success of the project, leaving the distinct impression, even in Menz's mind, that Fryar had purchased the bonds himself and with his own money.

On April 20, 1982, the underwriters and Westside closed the bond deal. The underwriters subscribed to the entire issue of bonds and undertook the task of selling it. The underwriters sold the bonds at approximately par value (except for the 14% bonds, which were sold at a discount). The underwriters found no difficulty in selling Westside bonds, and the entire issue was marketed quickly.

Two of the new investors in Westside bonds were plaintiffs Carey Walton and Edward Abell, both of whom testified that they bought their bonds from Dick Hardwick, a broker for Swink. Walton said he relied upon the integrity and competence of the broker, with whom he had dealt before, and upon a flyer Swink had circulated

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3. David Menz, the WLJ partner who represented the underwriters, testified that he thought the Booz, Allen feasibility report was irrelevant because the subsequent Booz, Allen letter seemed to suggest that the change in targeted clientele made the old report obsolete.

without WLJ's advice, knowledge, or control. Abell testified that he relied upon Walton's glowing reports and Walton's confidence in Swink and its broker.

Both Abell and Walton testified that they would have evaluated Westside bonds differently had they known about the Booz, Allen study, the details of the Cheneyville land transaction, and the fact that Fryar had not pledged any of his own bonds or his own money to complete the project. Both witnesses stressed heavily that the developer's apparent willingness to put $2,000,000 of his own money into the project impressed them greatly and influenced their decisions implicitly.

Over the next year and a half, the Westside story began to unravel. A bank failure and several delays cost Westside a substantial sum, though no more than $300,000. A local newspaper began to uncover the details of the Cheneyville land transaction. Litigation arising from the bank failure forced Swink to send a reassuring letter to all bondholders. In that letter, dated January 20, 1983, however, Swink revealed all the information that had been withheld from the offering statements.

In early July 1984, Abell and Walston initiated this lawsuit on behalf of themselves and a class of 500 of Westside's bondholders. At that time, and for the next three months, Westside bonds continued to sell at or near their par value.

In October of 1984, Westside's financial structure finally collapsed. Westside defaulted on an interest payment on its bonds and ultimately was forced to file for Chapter XI bankruptcy in March 1985. The bondholders did not fare well in bankruptcy and, under Westside's

reorganization plan, are now entitled to considerably lower interest payments than originally promised.[4] As a result of its bankruptcy, Westside missed four bond interest payments from October 1984 through April 1986, resulting in a loss to the bondholders (as of the time of trial) of $3,402,146. Moreover, the reduced interest rates for the bonds caused an additional loss of $8,616,972 after the future income was discounted to present value as of the date of the trial. Consequently, the bondholders' total losses as of trial were $12,019,118. To add salt to these wounds, All American made $2,950,000 from the land transaction and the interest payments it received on its Westside bonds.

On the basis of these facts, the bondholders claim that WLJ, Fryar, and All American violated a cornucopia of federal and state securities laws, civil racketeering laws, and a variety of state laws. They argue that WLJ and Fryar violated section 12 of the Securities Act of 1933 ("Securities Act") and the Louisiana Blue Sky Law ("LBSL"), and owe the plaintiffs rescissionary damages; that WLJ, Fryar, and All American violated the securities fraud provisions of section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and rule 10b-5 (derived from section 10(b)), and owe the bondholders

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4. The bond indebtedness was restructured in bankruptcy so as to reduce the interest rates of the bonds as follows:

| Original Rate | Restructured Rate |
|---|---|
| 16.50% | 10.50% |
| 16.25% | 10.15% |
| 16.00% | 10.30% |
| 14.00% | 8.85% |

actual damages; that Fryar and All American operated Westside for the purpose of committing securities fraud, mail fraud, and wire fraud, and owe the bondholders treble damages for the injury Fryar and All American did to the bondholders' property; and that all three defendants committed a variety of state-law torts for which they owe the bondholders actual damages.[5] The bondholders also sued Valley Forge, WLJ's insurer, to hold it derivatively responsible for all of WLJ's liability.

The jury returned a verdict in favor of the bondholders on all counts, and the court entered judgment upon that verdict. All of the defendants appealed, but All American failed to post court costs and a bond in a timely fashion, and we have already dismissed its appeal for lack of prosecution. We now turn to the issues concerning each of the other three defendants, and to the question of whether they deserve a new trial because of jury tampering.

II. *Section 12 of the Securities Act.*

First, the bondholders assert that Fryar and WLJ owe them rescissionary damages under section 12 of the Securities Act, 15 U.S.C. § 77*l*. WLJ and Fryar interpose a variety of defenses, among which is the claim that neither qualifies as a "seller" under either section 12(1) or section 12(2). Since only a statutory "seller" can be held liable

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5. Additionally, bondholders sued Skye; Swink; Hancock; Hancock, Joseph & Daniels; Peck; Peck, Shaffer & Williams; Westside's president; and several of the companies that insured them. All of these defendants settled with the bondholders before trial.

under section 12, this defense, if correct, would completely absolve WLJ and Fryar.

We begin our analysis, as always, with the language of the statute itself. Under section 12, "[a]ny person who . . . offers or sells a security" in violation of the section's provisions "shall be liable to the person purchasing such security from him." 15 U.S.C. § 77*l*.[6] We do not begin with a blank slate, however, since the Supreme Court has recently interpreted this language authoritatively.

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6. Section 12 reads in its entirety:

> Any person who –
>
> (1) offers or sells a security in violation of section 77e of this title, or
>
> (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

In *Pinter v. Dahl*, ___ U.S. ___, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988), the Supreme Court decided whom courts may treat as "sellers" under section 12. Pinter, an oil and gas producer who sold securities, sought contribution from Dahl to satisfy a judgment in favor of investors who had purchased unregistered securities from Pinter. Pinter argued that Dahl should share in Pinter's section 12(1) liability,[7] since Dahl had actively promoted the securities among his friends and relatives, the disgruntled investors in the original suit. Dahl replied that he had merely recommended the Pinter securities because he had thought that they would benefit their owners. Dahl argued that he could not be a "seller" under section 12(1) because he had not acted from a motivation of personal gain.

The Court first analyzed the language of the statute which we have set out above. The Court noted that the term "seller," which includes anyone who "offers . . . a security," is not restricted to those who pass title in securities to investors:

> Section 2(3) defines 'sale' or 'sell' to include 'every contract of sale or disposition of a security or interest in a security, for value,' and the terms 'offer to sell,' 'offer for sale,' or 'offer' to include 'every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.' 15 U.S.C. § 77b(3). . . . The inclusion of the phrase 'solicitation of an offer to buy' within the definition of 'offer' brings an individual who engages in solicitation, an

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7. Section 5 of the Securities Act, 15 U.S.C. § 77e, prohibits the sale of unregistered securities not exempted under section 3 of the Securities Act, 15 U.S.C. § 77c.

> activity not inherently confined to the actual owner, within the scope of § 12. . . . 'The statutory terms ["offer" and "sell"], which congress expressly intended to define broadly, . . . are expansive enough to encompass the entire selling process, including the seller/agent transaction.'

*Pinter*, 108 S.Ct. at 2076-77 (quoting *United States v. Naftalin*, 441 U.S. 768, 773, 99 S.Ct. 2077, 2082, 60 L.Ed.2d 624 (1979)).

Although the Court held that the "offers or sells" phrase in section 12 does not limit greatly the scope of section 12(1), it reasoned that the "purchase from" language of section 12 further restricts the range of potential sellers. The Court held that a defendant is not a "seller" unless the defendant "would commonly be said, and would be thought by the buyer, to be among those 'from' whom the buyer 'purchased'. . . ." *Id.* at 2077. Siding with Dahl, the Court added:

> When a person who urges another to make a securities purchase acts merely to assist the buyer, not only is it uncommon to say that the buyer 'purchased' from him, but it is also strained to describe the giving of gratuitous advice, even strongly or enthusiastically, as 'soliciting.' . . . The language and purpose of § 12(1) suggest that liability extends only to the person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner.

*Id.* at 2078-79.

The definition of "seller," as the *Pinter* court has articulated it, requires us to make two inquiries: (1) Who passed title to the plaintiff or solicited the transaction in which title passed; and (2) from whom did the plaintiff buy the security? We may answer the first question according to the standards of legal parsing and linguistic

analysis, but to answer the second question, we must refer to common usage.

Here, all of the plaintiffs bought Westside bonds from brokers or previous owners. Some of the plaintiffs, like Abell and Walton, bought their bonds from employees (who were brokers) of Swink & Co., one of the underwriters. It *might* be said that everyone who invested in the initial offering bought from the underwriters and Westside, the issuer.[8] None of the investors, however, can say that he or she bought bonds from the developer of the project which the bond issue supports, or from one of the law firms that helped to prepare the offering statement. If we apply the principles of *Pinter* to this case, we must hold that neither Fryar nor WLJ is a "seller" under section 12(2).

The bondholders suggest that *Pinter* is inapposite here. They do not deny that the "sell or offer" and "purchase from" language of section 12(2) is identical to the language the Court interpreted in *Pinter*. They note, however, that the Court explicitly reserved the right to

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8. Like automobile manufacturers, issuers create distribution chains composed of independent businesses aligned for a single purpose: to sell the product. Just as Ford and General Motors never sell directly to consumers, many issuers never sell their securities directly to investors. Nonetheless, automobile manufacturers engage in intensive marketing campaigns to convince the public to buy their products from dealerships readily identified with the manufacturer. Consequently, one often hears that someone "has bought a new car from Ford." To the extent that issuers and underwriters use an analogous system to distribute securities, they too may be sellers from whom one buys products.

interpret the section 12(2) language differently. *See* 108 S.Ct. at 2076 n. 20.

The plaintiffs contend that policy reasons favor divergent interpretations of the identical words of sections 12(1) and 12(2). They argue that the Court singled out section 12(1) because it imposes strict liability upon anyone who sells unregistered securities. Rather than import fault-based concepts, including proximate cause, to interpret section 12(1), the Court stuck closely to the language of section 12(1).

Thus, the Court (so sayeth the bondholders) rejected the substantial-factor test previously applied in this circuit[9] because that test defines as a "seller" anyone who proximately caused a securities transaction. The bondholders argue that the Court would accept the substantial-factor analysis to determine who is a *section 12(2)* seller because Congress incorporated traditional fault concepts into the elements of that subsection.

The Court, however, explicitly based its interpretation upon the plain language of section 12(1), not upon other factors, and presumably would do the same with section 12(2). *Pinter* teaches that

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9. We previously had defined a "seller" as (1) one who parts with title to securities in exchange for consideration or (2), one whose participation in the buy-sell transaction is a substantial factor in causing the transaction to take place. *Dahl v. Pinter*, 787 F.2d 985, 990 (5th Cir. 1986), *vact'd*, ___ U.S. ___, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988) (citing our prior cases), *on remand*, 857 F.2d 262 (5th Cir. 1988).

> [t]he deficiency of the substantial-factor test is that it divorces the analysis of seller status from any reference to the applicable statutory language and from any examination of § 12 in the context of the total statutory scheme. . . . Thus, although the substantial-factor test undoubtedly embraces persons who pass title and who solicit the purchase of unregistered securities as statutory sellers, the test also would extend § 12(1) liability to participants only remotely related to the relevant aspects of the sales transaction. *Indeed, it might expose securities professionals, such as accountants and lawyers, whose involvement is only the performance of their professional services, to § 12(1) strict liability for rescission. The buyer does not, in any meaningful sense, 'purchas[e] the security from' such a person.*

108 S.Ct. at 2080-81 (footnote omitted, emphasis added). Finally, the Court issued this warning:

> 'The ultimate question is one of congressional intent, not one of whether this Court thinks it can improve upon the statutory scheme that Congress enacted into law.' *Touche Ross & Co. v. Redington*, 442 U.S. [560] at 578, [99 S.Ct., 2479, at 2490, 61 L.Ed.2d 82 (1979)]. . . .The ascertainment of congressional intent with respect to the scope of liability created by a particular section of the Securities Act must rest primarily on the language of that section. See *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 . . . [97 S.Ct. 1292, 1300, 51 L.Ed.2d 480] (1977).

*Id.* at 2082.

We cannot ignore so plain a command. We hold that neither Fryar nor WLJ was a "seller" under section 12.

## III. *Rule 10b-5 Claims.*

Plaintiffs claim further that the defendants committed securities fraud in violation of section 10(b) of the Exchange Act. "To make out a claim under Section 10(b),

which is based on the common law action of deceit, the plaintiff must establish (1) a misstatement or an omission (2) of material fact (3) made with scienter (4) on which the plaintiff relied (5) that proximately caused his injury." *Huddleston v. Herman & MacLean*, 640 F.2d 534, 543 (5th Cir. Unit A Mar. 1981), *rev'd in part on other grounds*, 459 U.S. 375, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983).[10] The plaintiffs claim that they introduced substantial evidence to prove each of these elements against each of the defendants.

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10. Section 10(b) plaintiffs must also prove that the defendants committed the alleged fraud "in connection with a purchase or sale of securities," but that element is not in doubt here.

§ 10(b) reads, in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange – . . .
>
> (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 reads:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order

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The defendants do not assert that they never said or wrote anything false or misleading. However, the defendants do challenge the legal sufficiency of the bondholders' proof of materiality, reliance, and causation. WLJ also argues that it did not have the necessary scienter to violate rule 10b-5.

We will consider materiality first, followed by causation and reliance. Later, we will discuss WLJ's scienter arguments when we examine the potential for derivative rule 10b-5 liability under theories which the bondholders aim specifically at WLJ.

A. *Materiality.*

The defendants contend that the plaintiffs' complaints were not material. The defendants (but especially Fryar) question whether Westside said (or failed to disclose) anything that would have affected any investor's decision to buy Westside bonds. Defendants point out that none of the facts they distorted made any difference to investors when ultimately, in a January 1983 letter,

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to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1987).

Westside revealed all relevant facts.[11] Despite these revelations, the price (and apparently, the trading volume) of Westside bonds remained stable. Neither did the commencement of this lawsuit have any appreciable affect upon the market value of Westside bonds. From these facts, defendants conclude, as a matter of law, that the information which plaintiffs allege Westside fraudulently withheld was not material.

We begin by reviewing the standard for determining when a fact is material.For the purposes of the securities laws, "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 2132, 48 L.Ed.2d 757 (1976). To be a material fact, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.* The court has recently adopted these tests to determine materiality in all rule 10b-5 cases. *Basic Inc. v. Levinson*, ___ U.S. ___, 108 S.Ct. 978, 983, 99 L.Ed.2d 194 (1988).

Given this standard, we believe that the record sufficiently supports plaintiffs' position. The jury was entitled

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11. That letter, designed to calm investors' fears, disclosed the $2.4-million profit Fryar and All American collectively had made from selling land to Westside. It also revealed that Fryar used the money generated from this land transaction, not money originally his own, to secure his personal bonds backing the project. Finally, the letter reported the negative assessment which Booz, Allen had made of Fryar's 1983 Westside plans.

to believe that information that would have affected the market for Westside's initial offering would not have had the same effect two or three years later. Indeed, the jury heard expert testimony that Westside could not have marketed its bonds at all had it revealed the details of the Fryar-All American-Westside land transaction or of the Booz, Allen study.

Sheddy, who on behalf of underwriter Swink helped prepare the offering statement, admitted that the unreported facts were material. The brokers at Swink's Atlanta office deemed the information so significant that they offered to buy back Westside bonds from their customers when they first learned the truth. According to one of these brokers, Fryar's assurances that his *own* funds backed Westside significantly enhanced the project's image as a secure investment. This evidence sufficiently supports the jury's conclusion that Abell proved that a reasonable investor would have evaluated Westside's initial offering differently had *all* the information been available originally.

B. *Causation.*

Fryar attacks the sufficiency of the evidence to prove that Westside misrepresented facts that caused its eventual bankruptcy and thus the reduction in the interest rates the bonds bore. To prove causation, the bondholders must prove

> that the untruth was in some reasonably direct, or proximate, way responsible for [their] loss. The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value. If the

> investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant[s], but are not the proximate reason for [their] pecuniary loss, recovery under the Rule is not permitted.

*Huddleston*, 640 F.2d at 549 (footnote omitted).

Fryar asserts that the facts Abell would like to have known when Westside first offered its bonds have nothing to do with the causes of Westside's default on interest payments or its eventual bankruptcy.[12] He blames the bankruptcy of Penn Square Bank, which he contends dramatically affected Westside's cash position at a critical point in the project's development. Fryar argues that a change in state health-care reimbursement policies destroyed whatever hope Westside had of weathering its cash flow crunch. According to Fryar, these two combined factors forced Westside into bankruptcy.

The jury, however, found otherwise. The Cheneyville land transaction consumed a substantial portion of Westside's working capital. Of a $13.5 million bond offering, nearly $2.5 million – most of which Fryar and All American secreted for their own undisclosed use – was dedicated to this single transaction. In comparison, the Penn Square Bank failure cost Westside only $300,000 at most. Indeed, Fryar's own witness conceded that state health-care officials froze reimbursements to Westside when they first learned of the true details of the Cheneyville land transaction. The jury was entitled to believe that this

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12. Westside's reorganization plan siginficantly lowered the interest rate borne by Westside bonds.

real estate deal "touched upon" the reasons for Westside's ultimate bankruptcy.[13] Hence, causation was sufficiently established.

### C. *Reliance.*

The defendants also argue that the plaintiffs failed to prove that any plaintiff relied upon any fraudulent representations or omissions. The element of reliance is the subjective counterpart to the objective element of materiality. Whereas materiality requires the plaintiff to demonstrate how a "reasonable" investor would have viewed the defendants' statements and omissions, reliance requires a plaintiff to prove that it *actually* based its decisions upon the defendants' misstatements or omissions. "Reliance is *causa sine qua non*, a type of 'but for' requirement: had the investor known the truth he would not have acted." *Huddleston*, *id.* at 549 (footnote omitted). Thus,

> [c]ourts sometimes consider the reliance component of the Rule 10b-5 action to be a part of the causation element. In this context, the term 'transaction causation' is used to describe the requirement that the defendant's fraud must precipitate the investment decision. . . . On the other hand, 'loss causation' refers to a direct causal link between the misstatement and the claimant's economic loss.

*Id.* at 549 n. 24 (citation omitted).

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13. We express no opinion regarding any other of Abell's theories of this case (e.g., that the Booz, Allen study revealed otherwise-undisclosed facts that contributed to Westside's bankruptcy). Our task is not to justify the jury verdict, but to ascertain whether the evidence sufficiently supported at least one view of the facts to permit a verdict for the plaintiffs.

### 1. *Proving Reliance for the Class as a Whole.*

Since rule 10b-5 plaintiffs must prove that *each* plaintiff subjectively relied upon the defendants' misstatements and omissions, the jury may not infer the reliance of an entire class of plaintiffs from the testimony of a few. "Consequently, in a class action, while the materiality element can be established for the class as a whole, reliance, like damages, is a matter of individual proof." *Huddleston, id.* at 549 (citation omitted).

Here, neither side introduced *any* evidence to demonstrate or refute whether most of the class members decided to buy Westside bonds in reliance upon what the defendants said or failed to say. Whether the jury was permitted to infer reliance from the evidence, therefore, depends entirely upon who bore the burden of persuasion. That burden ordinarily rests with plaintiffs, but it may shift in those rare cases in which plaintiffs can prove that they are entitled to one of two presumptions.

The more venerable presumption, the so-called *Ute* presumption, is available to plaintiffs who can prove that the rule 10b-5 violations which they allege actually stem from defendants' failure to disclose pertinent information rather than from defendants' failure to tell the truth. The other presumption plaintiffs may invoke – the theory that defendants committed a fraud upon the marketplace – is of more recent vintage. We discuss each of these burden-shifting presumptions in turn.

### a. *The Ute Presumption*

The *Ute* presumption was first announced by the Supreme Court in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972). There, an organization of native Americans organized a corporation to distribute its assets to its members. Each member received title to ten shares of stock that were deposited with a local bank. The bank entered into a fiduciary relationship with the new stockholders and assumed primary responsibility for enforcing title restrictions and providing other services related to the stock.

Ultimately, investors in surrounding communities developed an interest in the stock, and demand in these communities outstripped the Utes' demand for the corporation's stock. The bank seized this opportunity quietly to build a non-native American clientele eager to invest in Ute stock. The native Americans, however, never heard about this secondary market for their stock, and the bank chose to keep them ignorant to exploit its potential financial gains.

When the Utes eventually did learn of the bank's scheme, eighty-five of them sued. The plaintiffs were Utes who, trusting in the bank, had sold their stock to the bank for prices that sometimes were significantly lower than what the bank could command in the open market. The native Americans complained that the bank had breached a fiduciary duty to them to disclose information about the secondary market, and sued the bank for violating rule 10b-5. The bank responded in part by arguing that the plaintiffs had failed to prove reliance.

The Supreme Court held that the burden of proving reliance fell on the bank, not on the plaintiffs. As our subsequent cases have taught, the *Ute* presumption attaches only to those rule 10b-5 actions based primarily upon omissions rather than misrepresentations.[14]

Misrepresentations include statements that are themselves false – outright lies – and true statements that are nonetheless so incomplete as to be misleading, i.e., distorted half-truths. To omit a fact, however, is to say absolutely nothing about matters whose very existence plaintiffs have no reason to consider. The bank in *Ute* omitted material facts: The Utes simply had no idea that the bank itself actively solicited non-native-American investors to buy Ute stock.[15] These omissions were not

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14. To state a claim under rule 10b-5, a plaintiff must allege either that the defendant misrepresented material facts or omitted material facts which a pre-existing duty required it to disclose to the plaintiff. We have held that claims based upon misrepresentations sound in part 2 of rule 10b-5, whereas claims based upon omissions are founded upon parts 1 and 3 of the rule. *See, e.g., Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 359-60 (5th Cir. 1987), *cert. denied*, ___ U.S. ___, 108 S.Ct. 1220, 99 L.Ed.2d 421 (1988). *See supra* n. 10 for the text of rule 10b-5.

15. To define more vividly the distinction between misrepresentations and omissions, we suggest the following hypothetical: Suppose a car owner, wishing to sell her vehicle, advertises in the newspaper that her car has a "new" battery when she knows the battery is five years old. She has communicated an outright lie, and the basis of a fraud against her is falsehood (a category of misrepresentation). If

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distorted half-truths, since the bank never made *any* statements regarding its activity in the secondary market.

Our cases indicate that the *Ute* presumption is limited to cases, like *Ute* itself, in which the plaintiffs have based their complaint primarily upon alleged omissions. Such non-disclosure suits are those in which the complaint is grounded primarily in allegations that the defendant has failed to disclose any information whatsoever relating to material facts about which the defendant has a duty to the plaintiff to disclose. *Ute*, however, does not require the burden of persuasion to shift in cases where the plaintiffs allege either that the defendant has made false statements or has distorted the truth by making false but misleading incomplete statements. Thus, we apply the *Ute* presumption in non-disclosure cases, but not in falsehood of distortion cases. *See, e.g., Finkel*, 817 F.2d 359.

Here, the bondholders characterize this case as involving primarily omissions. Their claim is that the offering documents represented that Westside was feasible, when it was not; that Fryar was to have $2 million of his own money in the transaction, when he did not; and

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a prospective buyer asks her, "How is the engine?", she might reply, "I've never had a problem with it." If, however, she has owned the car for only a few weeks, and knows that the previous owner had the engine rebuilt two months ago, she has distorted the truth by telling only part of it – another form of misrepresentation. Finally, assume the owner has decided to sell her automobile because a mechanic she knows considers the vehicle "not safe at any speed." Nonetheless, she tells this only to potential buyers who specifically ask her why she is selling the car. In this last case, the owner has omitted saying anything about a particular material matter.

that the real estate had a value or cost basis to Westside of over $2.4 million, when it did not. Although we have held these statements to have been both false and material, they are distortions, not omissions.

The bondholders have not argued that Fryar failed to disclose facts about which the investors had *no* inkling, but that Fryar purposely revealed only part of the truth in an effort to mislead potential purchasers. The plaintiffs attempted to portray the defendants as creating an impression of Westside that was entirely false, induced by a deceptively misleading impression about the offering; thus the plaintiffs are not entitled to the *Ute* presumption.

b. *The Fraud-on-the-Market Presumption*

The bondholders argue that we should assume that they relied upon the market for Westside bonds to set a fair price unadulterated by fraud. Under this theory of their case, the bondholders essentially contend that investors uniformly assume that an active and open securities market efficiently assimilates information about securities. The market then calibrates the price of a security to reflect precisely the security's value in light of all the information publicly available about that security. Provided that the publicly available information is both accurate and complete, the market price contains the most accurate and succinct estimation of the true value of any given security at any given time. Consequently, investors, who must assume the integrity of the market and of those who trade in it, ordinarily rely heavily upon the market price in determining the values of securities.

This theory of the marketplace underlies a recent development in securities law – the "fraud-on-the-market" theory of reliance. A "fraud on the market" is any deceit that successfully disseminates false or misleading information into the securities market or withholds vital information from that market. Such a deceit defrauds investors even when they are unaware of the misrepresentations or omissions that skew the market price, because investors depend heavily upon the integrity of the market price. Thus, the argument goes, courts should presume reliance in a class action because most (if not all) of the investors have relied upon the accuracy of a fraudulently distorted market price. *See, e.g., Basic Inc. v. Levinson*, 108 S.Ct. at 988-92.

In recent years, this theory of reliance rapidly has gained support. In *Shores v. Sklar*, 647 F.2d 462 (5th Cir. May 1981) (en banc), *cert. denied*, 459 U.S. 1102, 103 S.Ct. 722, 74 L.Ed.2d 949 (1983), we adopted a form of the fraud-on-the-market presumption of reliance. Since *Shores*, the Supreme Court in *Basic Inc. v. Levinson* has announced its support for a new, largely undefined version of this presumption of reliance.

*Basic* states only three propositions of law that are of interest here. First, the Court ruled that a trial court *may* presume reliance on the ground that the defendant committed a fraud on the market. Second, *Basic* explicitly holds that the "fraud-on-the-market" presumption is rebuttable and serves only to shift the burden of persuasion, as to reliance, onto securities fraud defendants. Finally, the Court vitiated part of our fraud-on-the-market jurisprudence.

Until *Basic*, we made the fraud-on-the-market presumption, like the *Ute* presumption, available only to plaintiffs who based their rule 10b-5 claims primarily upon nondisclosure. *See, e.g., Finkel v. Docutel/Olivetti Corp.*, 817 F.2d at 359. *Basic*, however, held that a rule 10b-5 plaintiff alleging active misrepresentation (i.e., making false statements and failing to correct distorted statements) may also assert a fraud-on-the-market theory of reliance.[16]

> Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations. . . . Indeed, nearly every court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed. . . . An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

*Basic*, 108 S.Ct. at 991-92 (footnotes omitted). Nonetheless, *Basic* essentially allows each of the circuits room to develop its own fraud-on-the-market rules. Consequently, we return to our own cases.

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16. The plaintiffs in *Basic* were former stockholders in a company that falsely denied the existence of merger talks. The plaintiffs sold their stock before the merger negotiations drove up stock prices.

In *Finkel*, the most recent Fifth Circuit case to consider the fraud-on-the-market theory, we held that a rule 10b-5 plaintiff may establish fraud on the market in two different ways. First, the plaintiff can establish that the subject securities were traded on an active secondary market, such as a public exchange. In such a case, the plaintiff would prevail if he could prove that the defendant's non-disclosures materially affected the market price of the security. 817 F.2d at 364.

Where, however, no active, efficient secondary market existed in which to trade the subject securities (as in *Shores*), the plaintiff must prove that "the defendants conspired to bring to market securities that were not entitled to be marketed." *Id.* at 362. *Shores* states this same concept in slightly different terms:

> If [the plaintiff] proves no more than that the bonds would have been offered at a lower price or a higher rate, rather than that they would never have been issued or marketed, he cannot recover. . . . This theory is not that [the plaintiff] bought inferior bonds, but that the Bonds he bought were fraudulently marketed. The securities laws allow an investor to rely on the integrity of the market to the extent that the securities it offers to him for purchase are entitled to be in the market place.

*Shores*, 647 F.2d at 470-71.

The plaintiffs here argue first that the market price, set in active bond markets, was distorted by defendants' fraud. The bondholders contend that Westside bonds were traded in an active secondary market through brokers. They add that Westside's finances, of which the public originally had only a materially distorted view, eventually caused the value of the bonds to collapse.

This argument, however, completely ignores *Shores*, which, in this respect, is factually indistinguishable from the present case. In *Shores*, as here, the defendants included private entrepreneurs who obtained a town's authorization to issue municipal bonds underwriting a local, private project. Both here and in *Shores*, the entrepreneurs hired underwriters to sell the new issue to the public. In both cases, a small secondary market, exploited by brokers, developed for the bonds. However, the bonds in *Shores*, like the bonds here, were not actively traded on any exchange or in any large secondary market. As we observed later in *Finkel*,

> . . . it is clear that the market for the bonds in *Shores* (industrial development bonds of the town of Frisco City, Alabama) does not represent the active, efficient market for which the fraud on the market theory was initially conceived.

*Finkel*, 817 F.2d at 364.

Next, the bondholders argue that they deserve the fraud-on-the-market presumption because the Westside offering was not entitled to be marketed. The bondholders point to several experts who testified that the Westside bonds were unmarketable. According to the plaintiffs' experts, Westside could not have disclosed its true financial status and the negative conclusions of the Booz, Allen feasibility study without completely losing a market for their bonds. These experts also opined that no underwriter would have been willing to shoulder Westside's offering if the weight of the task included trying to explain away Fryar's suspicious land transactions and the Booz, Allen study.

The bondholders claim that this testimony proves that, like the securities in *Shores*, the Westside bonds were brought to market only through fraud, and were not entitled to be marketed at all. The defendants respond that only worthless securities are not entitled to be marketed under *Shores*. They argue that if the bonds retained any value at all, the plaintiffs have shown "no more than that the bonds would have been offered at a lower price or a higher rate. . . ." *Shores*, 647 F.2d at 470. According to the defendants, the plaintiffs' theory is only that they bought inferior bonds, not as *Shores* requires, that they bought bonds fraudulently brought to market. *Id.* at 471.

The bondholders argue that worthlessness is not a prerequisite, under *Shores*, for establishing a fraud on the market. The bondholders correctly note that the *Shores* plaintiffs recouped about 37 percent of their investment when the municipal assets dedicated to the failed corporation were liquidated. They conclude that the *Shores* stocks were not worthless and that worthlessness, therefore, cannot be the touchstone of a fraud-on-the-market analysis.

This argument misses the point, since saleable assets may bless even the most worthless enterprise. In *Shores*, the illegitimate securities represented an investment in a hoax made to seem real because valuable assets, including a factory, backed the promoters' promises. Although the assets may have added value to the securities, the sham "business" did not because the promoters never intended to start a legitimate one.

We hold, therefore, that securities meet the test of "not entitled to be marketed" only where the promoters

knew the enterprise itself was patently worthless. We add that expert testimony, however well-founded in the experience of securities traders, is nothing more than the speculation of observers benefiting from hindsight. All of the careful analysis of securities pundits and expert calculations of experienced investors cannot replace the irrefutable knowledge gained from a single source: the actual track record of the security itself.

*Shores* established a test more sensitive to the historic value of the subject securities than the bondholders acknowledge. As we said in *Shores*, a securities fraud plaintiff must argue not "that he bought bonds, but that the bonds he bought were fraudulently marketed." *Id.* at 471. *Finkel* succinctly characterized this test:

> The majority in *Shores* simply recognized that a Rule 10b-5 action based on the fraud on the market theory could embrace a claim for a fraud that resulted in the issuance of worthless securities as well as a fraud that inflated the price of a security.

817 F.2d at 364 (footnote omitted).

Here, the bondholders' argument fails because the Westside bonds *always* had a legitimate value in the bond market. Indeed, these bonds remained near market value for several years *after* Westside disclosed the accurate version of its beginning and several months *after* this lawsuit commenced.

Moreover, we perceive strong policy reasons to reject the bondholders' contentions. The plaintiffs' position would attenuate the fraud-on-the-market presumption of reliance far beyond its proper bounds and almost entirely

extinguish reliance as a legitimate element of a rule 10b-5 claim. This presumption assumes that investors ordinarily and correctly rely upon the "market price" of a security as an accurate estimate of the future value of that security. Accordingly, if a defendant distorts the market price by lying or concealing the truth, the fraudulently-distorted price can deceive even prudent investors.

This theory, however, implicitly assumes that there is an active, efficient secondary market capable of accurately measuring the present and future value of a security. Moreover, the theory supposes that most investors seek out securities whose prices the market accurately reflects.

Where, as here, investors seek out *underpriced* securities that are traded outside efficient secondary markets, the fraud-on-the-market theory of reliance no longer makes sense. Investors can no longer be said to have relied upon an established market price, which, if it exists at all, reflects an inherently unstable and probably inaccurate estimate of the security's actual value. Moreover, Abell has never argued – indeed, the evidence belies such an argument – that Westdside bonds *ever* lacked *any* value. Given the inherently imprecise means available to measure the actual value of Westside bonds at any given point in time, Abell's argument that the members of the plaintiff class presumably relied upon the market price for those bonds is unconvincing.

Consequently, we reject bondholders' arguments and hold that the fraud-on-the-market presumption of reliance is available only (1) where the subject securities were traded actively in large markets, or (2) where the

promoters knew that the subject enterprise was worthless when the securities were issued, and successfully issued the securities only because of defendants' fraudulent scheme. Since the Westside bonds fail to meet either test, and since the *Ute* presumption is here unavailable, plaintiffs have failed to establish reliance for the class, and the class's rule 10b-5 claim must fail.

### 2. *Reliance of Some Individual Members of the Class.*

Two of the individual plaintiffs, Abell and Walton, testified that they did in fact rely upon the defendants' misrepresentations. Walton testified that he considered the attractive interest rate which the bonds bore, a Swink flyer that had not been authorized by WLJ and the advice of Dick Hardwick, a Swink broker. Abell testified that he relied upon the attractive interest rate, Hardwick's reputation as a broker, the fact that Westside bonds were Louisiana municipal bonds, and Fryar's promise to invest $2,000,000 of his own cash in Westside. We conclude that this testimony, which was uncontradicted at trial, is enough to establish that Abell and Walton relied upon Fryar's misrepresentations. We do not, however, think that it is sufficient to prove that Abell and Walton relied upon anything which WLJ said or did.

WLJ never had any direct contract with Westside's bondholders. Consequently, the bondholders may not assert that WLJ misrepresented or failed to disclose any material facts directly *to the bondholders*. Instead, WLJ limited its role in the Westside bond-offering to the legal work it did for the bond underwriters. Consequently, WLJ never made any statements on its own behalf

directly to the bondholders, but only checked and revised the statements made in the offering statement.

Neither Abell nor Walton testified that he relied upon that statement. Instead, their own testimony indicates that they relied only upon the attractiveness of the offer, *Fryar's* misrepresentation as to his own investment in Westside, and Swink's misguided (or fraudulent) assessment of the bonds' value. Neither Swink, which knew more about the bonds than it cared to reveal in the offering statement, nor Abell and Walton, who did not seem to care what the offering statement actually said, can be said to have relied upon the offering statement itself.

Consequently, none of the plaintiffs has proved that he relied upon WLJ's legal opinion, however good or bad that opinion may have been. From our foregoing analysis, we conclude that Abell and Walton have shown that Fryar and the underwriters, but not WLJ, have violated rule 10b-5 and are liable to Abell and Walton for damages.

Thus, Abell and Walton (but not the class) have shown that Fryar misrepresented material facts, that they relied upon these misrepresentations in choosing to buy Westside bonds, and that Westside's actual financial structure eventually caused Abell's and Walton's losses. Abell and Walton did not prove, however, that anyone ever relied upon anything WLJ did, said, or wrote. Thus, they have not proven that WLJ violated rule 10b-5 directly. Our analysis, however, does not suggest that WLJ is not vicariously liable for the role the underwriters

played in executing Fryar's fraud.[17] We next analyze that theory.

### D. *WLJ's Potential Vicarious Liability.*

The bondholders suggest that, under two separate theories, WLJ is vicariously liable for Fryar's and the underwriters' fraud. The plaintiffs assert first that WLJ had a special duty, as underwriters' counsel, to the investing public to ferret out and disclose publicly any fraud. Second, according to the bondholders, WLJ rendered substantial assistance to the fraudulent scheme despite the unmistakable signs that fraud was afoot. By turning a blind eye to these signs, the bondholders argue, WLJ subjected itself to rule 10b-5 liability for aiding and abetting securities fraud. We examine each of these arguments in turn.

#### 1. *Duty To Disclose.*

The bondholders argue that WLJ implicitly guaranteed the accuracy of the offering statement to the investing public. According to the bondholders, WLJ impliedly assumed a duty to correct all material misrepresentations in the offering statement when it agreed to assume the responsiblilites of an underwriter's counsel. Thus, the

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17. WLJ does not argue that, at most, only Fryar committed fraud. Since WLJ does not challenge the jury's finding that the underwriters participated in the fraud, we accept the jury's verdict.

bondholders conclude, WLJ issued deficient legal opinions, subjecting it to liability, because it failed to discover and disclose Fryar's fraud.

The bondholders derived this proposition of law from four well-established practices of the securities bar. First, underwriter's counsel, acting on behalf of the underwriter, traditionally prepares the offering statement. Second, underwriter's counsel assumes a due-diligence duty to ensure that the offering statement is correct in all material respects. Third, this due-diligence duty derives from the fraud provisions of the securities laws, which themselves exist primarily to protect innocent investors. Fourth, Westside's offering statement listed WLJ as underwriter's counsel – a fact that suggests to the plaintiffs that WLJ impiicitiy took public responsibility for the legal sufficiency of the offering statement itself.

We cannot agree with the bondholders' argument. Traditionally, lawyers are accountable only to their clients for the sufficiency of their legal opinions. It is well understood in the legal community that any significant increase in attorney liability to third parties could have a dramatic effect upon our entire system of legal ethics.[18] An attorney required by law to disclose "material facts" to third

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18. *See, e.g., First Mun. Leasing Corp. v. Blankenship, Potts, Aikman, Hagin & Stewart*, 648 S.W.2d 410, 413 (Tex.App, 5 Dist.1983, writ ref'd n.r.e) (refusing to extend attorney malpractice claims to third parties not in privity with the defendant lawyer); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 497 (7th Cir.1986) ("[L]awyers . . . are [not] required to tattle on their clients in the absence of some duty

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parties might thus breach his or her duty, required by good ethical standards, to keep attorney-client confidences. Similarly, an attorney required to declare publicly his or her legal opinion of a client's actions and statements may find it impossible to remain as loyal to the client as legal ethics properly require.[19]

Cognizant of these risks, the law, as a general rule, only rarely allows third parties to maintain a cause of action against lawyers for the insufficiency of their legal opinions. In general, the law recognizes such suits only if the non-client plaintiff can prove that the attorney prepared specific legal documents that represent explicitly the legal opinion of the attorney preparing them, for the benefit of the plaintiff.[20] *Goodman*, 556 P.2d at 743; *Bush*, 619 F.Supp. at 596.

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to disclose. To the contrary, attorneys have privileges not to disclose" (citations omitted).); *Goodman v. Kennedy*, 18 Cal.3d 335, 134 Cal.Rptr. 375, 556 P.2d 737, 743 (Cal.1976) (if attorneys were liable to both clients and other parties to arms-length transactions, attorneys would become self-protective and could not fulfill counseling role).

19. *See Barker; Page v. Frazier*, 388 Mass. 55, 445 N.E.2d 148, 153 (1983) (absent separate attorney-client relationship, lawyer owes no duty of reasonable care to adverse party because of attorney's conflicting duty to client); *Bush v. Rewald*, 619 F.Supp. 585 (D.Haw.1985) (lawyer owed no duty to investors buying from organization where organization, not investors, was attorney's client).

20. This rule, which a growing number of states have adopted for imposing liability for negligently-rendered opinions, reflects the increasing influence of Restatement (Second) of Torts § 552 (1977). That section provides:

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In practice, this rule has meant that an attorney is rarely liable to any third party for his or her legal work unless the attorney has prepared a signed "opinion" letter designed for the use of a third party. *Compare S.E.C. v.*

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> *Information Negligently Supplied for the Guidance of Others*
> (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
> (2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered
>
> (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
>
> (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.
>
> (3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

Section 552, however, has not affected legal malpractice law as much as that provision has impacted other areas of malpractice law. A majority of states still require privity between legal malpractice plaintiffs and defendants. *See generally* Annotation, *What Constitutes Negligence Sufficient To Render Attorney Liable to Person Other than Immediate Client*, 61 A.L.R. 4th 464 (1988); Annotation, *Atorney's Liability, to One Other than Immediate Client, for Negligence in Connection with Legal Duties*, 61 A.L.R. 4th 615 (1988). *See also First Mun. Leasing Corp.*, 648 S.W.2d at 413.

*Spectrum, Ltd.*, 489 F.2d 535 (2d Cir.1973) (plaintiff may state rule 10b-5 action against attorney who signed an opinion letter another had declined to sign) *with Keene Corp. v. Weber*, 394 F.Supp. 787 (S.D.N.Y.1975) (attorney not liable under rule 10b-5 because no misleading opinion letter at issue).

The bondholder plaintiffs argue that other courts have established less restrictive tests to determine whether securities lawyers are liable to those who invest in securities the lawyers' clients have issued or underwritten. The three most relevant are *Spectrum; Cronin v. Midwestern Dev. Auth.*, 619 F.2d 856, 862 (10th Cir.1980); and *In re Flight Transp. Corp. Sec. Litig.*, 593 F.Supp. 612, 617-18 (D.Minn.1984).

In *Spectrum*, however, the Second Circuit held a lawyer liable under rule 10b-5 because he signed a critical opinion letter which another lawyer, who escaped liability, had refused to sign. *Accord, Keene Corp.* (describing the holding of *Spectrum*). In *Cronin*, the Tenth Circuit suggested that courts could impose rule 10b-5 liability upon bond counsel, who ordinarily does issue an opinion letter that comes attached to the offering statement or prospectus.

Of the three cases, only *Flight Transp. Corp.* squarely departs from the traditional rule to impose rule 10b-5 liability upon all underwriter's counsel. *Flight Trans. Corp.* however, has no precedential value here, and we find its reasoning unconvincing.[21] Since we can find no

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21. The bondholders cite numerous other cases to support their position, but most are easily distinguishable. Several

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binding authority creating a special rule in the field of securities law,[22] we decline to depart from either rule or practice here.

Plaintiffs presented almost no evidence that WLJ's due diligence duties existed to benefit or protect the investing public at large. Rather, bondholders proved only that WLJ had a duty to its clients to ensure that they complied with securities laws. The mere fact that these laws were designed to protect the investing public does not convince us that WLJ assumed more than the duty to

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impose liability upon lawyers who issued opinion letters. *E.g., Morgan v. Prudential Group, Inc.*, 527 F.Supp. 957 (S.D.N.Y.1981), *aff'd.*, 729 F.2d 1443 (2d Cir.1983). Others involve lawyers who stepped out of their professional legal roles and actively promoted the securities (*e.g., S.E.C. v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1095 (2d Cir.1972)), or attorneys who were sued by their own clients (*e.g., DCD Programs, Ltd. v. Leighton*, 833 F.2d 183, 190 (9th Cir.1987)). The remaining cases are district court cases with little precedential weight here.

22. We have failed also to find any authority requiring us to follow the genaral rule here. WLJ cites us to *Dirks v. S.E.C.*, 463 U.S. 646, 103 S.Ct. 3255, 77 L.Ed.2d 911 (1983), and *Chiarella v. United States*, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980), but we find these cases inapposite here. Both *Chiarella* and *Dirks* analyzed cases in which the S.E.C. charged the defendants with having breached a specialized, pre-existing duty to disclose certain facts. In these cases, the S.E.C.'s claims rested upon whether the defendants had a duty to speak when they preferred to remain completely silent. Here, by contrast, the plaintiffs have alleged that WLJ, by its actions, adopted the false statements and distortions made by its clients. The claimed duty here, then is not a duty to speak rather than remain silent, but a duty to correct false statements and distortions rather than acquiesce in them.

protect its own clients from legal liability. "The securities laws do not impose liability for ordinary malpractice, even though that malpractice may diminish the value of the issuer and thus of the issuer's securities." *Barker, id.* at 496.

Nor do we believe that WLJ assumed any duties to these bondholders merely by allowing its name to be included in the final offering statement. We think it more significant that WLJ never *signed* the offering statement itself or any of the documents included in that statement. Moreover, the offering statement says only that WLJ passed on legal issues *for the underwriters,* its clients. By contrast, the offering statement does *not* limit for whom the bond counsel had prepared his opinion. If any of the attorneys or law firms assumed legal responsibility for the sufficiency of the offering statement, it was bond counsel William Skye, who actually did sign a letter disclosing his own legal opinion regarding several aspects of the bond offering.

We join the Seventh Circuit, which, in *Barker, id.* at 497, commented:

> We express no opinion on whether the [attorneys] did what they should [or] whether there was malpractice under state law. . . . We are satisfied, however, that an award of damages under the securities laws is not the way to blaze the trail toward improved ethical standards in the legal and accounting professions. Liability depends on an *existing* duty to disclose. . . . The plaintiffs have not pointed to any rule imposing on [attorneys] a duty to blow the whistle. [Emphasis in original.]

Accordingly, WLJ owed no duty of disclosure to the bondholders.

2. *Aiding and Abetting.*

Finally, the bondholders argue that even if WLJ did not itself commit securities fraud, it nonetheless aided and abetted Fryar and Swink in their scheme to commit securities fraud. As the plaintiffs correctly note, our cases impose section 10b-5 liability upon those who abet securities fraud. *Woodward v. Metro Bank,* 522 F.2d 84 (5th Cir.1975).

We have recently restated the *Woodward* test to determine who is subject to section 10b-5 aiding-and-abetting liability: (1) There must have been a securities violation by the primary party; (2) the aider and abettor must have had a "general awareness" of its role in a rule 10b-5 violation; and (3) the aider and abettor must have knowingly rendered "substantial assistance" in the rule 10b-5 violation. *Bane v. Sigmundr Exploration Corp.,* 848 F.2d 579, 581 (5th Cir.1988).

We have already held that substantial evidence supports the jury verdict that Fryar and the underwriters committed securities fraud. Moreover, WLJ does not challenge the bondholders' implicit assertion that it substantially assisted the underwriters in effecting their scheme. Thus, it remains only to determine whether WLJ was "generally aware" of its role in furthering the fraudulent scheme, and whether its assistance was "knowing."

In *Woodward,* we explained what these scienter requirements mean. "General awareness," we said, means knowledge which, though it may be adduced from reckless conduct, means actual awareness. 522 F.2d at 96. We also held that how "knowing" an abettor must be depends upon how substantial the abettor's assistance is:

> When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only

> if scienter of the high 'conscious intent' variety can be proved. Where some special duty of diclosure exists, then liability should be possible with a lesser degree of scienter. . . . In a case combining silence/inaction with affirmative assistance, the degree of knowledge required should depend on how ordinary the assisting activity is in the business involved. If the evidence shows no more than transactions constituting the daily grist of the mill, we would be loathe to find 10b-5 liability without clear proof of intent to violate the securities law. Conversely, if the method or transaction is atypical or lacks business justification, it may be possible to infer the knowledge necessary for aiding and abetting liability. In any case, the assistance must be substantial before liability can be imposed under 10b-5.

*Id.* at 97 (citations and footnotes omitted).

*Woodward* appears to divide scienter into two parts: knowledge of one's role in a fraud, and commitment (or intent) to aid in the fraud's success. Scienter, then, would require first that the alleged abettor know of the fraud's existence and generally understand how its actions aid in promoting the success of the fraud. The second element of scienter – commitment – would be met where evidence shows that the abettor acts from a desire to help the fraud succeed.

> Naturally, whether the plaintiff needs evidence independent of the abettor's actions to prove commitment depends upon the nature of the defendant-abettor's assistance. Silent acquiescence never indicates by itself that the abettor wants the fraudulent scheme to succeed; here, we usually require proof of "conscious intent." *Id.*

Even when an abettor takes positive actions that aid a nefarious plan, the abettor does not always approve of

the scheme's success. Thus, "we would be loathe to find 10b-5 liability without clear proof of intent to violate the securities laws" where the assistance amounts to "no more than transactions constituting the daily grist of the mill. . . ." *Id.* On the other hand, those who go out of their way to aid a fraud are generally the most willing and committed to its success.

If this view of *Woodward* is correct, then it would harmonize the law of rule 10b-5 aiding-and-abetting with its roots in the criminal law.[23] However, both the commentators and our sister circuits view the scienter requirement as a single rule that determines both one's level of awareness and "knowing and substantial assistance" according to the same rule. *See e.g., IIT, an Int'l Inv. Trust v. Cornfeld*, 619 F.2d 909, 923 (2d Cir. 1980) (Friendly, J.). Under this generally-accepted view, *Woodward* establishes a single test for scienter that varies as the level of assistance decreases on a sliding scale from recklessness to "conscious intent." Under either rule, however, we

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23. The federal criminal aiding and abetting statute requires that the alleged abettor share in the criminal intent of the principal and engage in affirmative conduct designed to aid the venture. *United States v. Ortiz-Loya*, 777 F.2d 973, 980 (5th Cir.1985). *Accord, United States v. Weddell*, 800 F.2d 1404, 1408 (5th Cir.), *modified*, 804 F.2d 1343 (5th Cir. 1986). "Thus, to sustain a conviction, the evidence and reasonable inference therefrom must show [the defendant] knew that a fraud was occurring, that he associated himself with that fraud, that he participated in it with a desire that it be accomplished, and that he committed some overt act designed to make it a success." *United States v. Westbo*, 746 F.2d 1022, 1025 (5th Cir.1984).

must determine whether the alchemy of WLJ's level of assistance, combined with its level of knowledge of the unfolding fraud, supports a jury verdict against WLJ. Here, we think it does not.

We review the evidence, as we must, in the light most favorable to the plaintiff bondholders. They established that WLJ knew that one of its clients (Hancock) was under SEC investigation for securities violations. The evidence also permitted the jury to conclude that WLJ knew that the FBI, the SEC, and the National Association of Securities Dealers were also investigating Hancock. Additionally, WLJ was aware that both the original underwriter's counsel and the original bond counsel had resigned from their representations – a further sign that something might be amiss.

Nonetheless, WLJ did little to investigate what its client had done previously or why the original counsel had resigned. Moreover, WLJ readily made several material changes to the final offering statement without asking its clients (who requested the changes) why they should be made. Finally (and again, according to the evidence most favorable to plaintiffs), WLJ failed to investigate properly the truth of the offering statement despite its duty to its clients to do so.[24]

We conclude that this evidence is not strong enough to sustain the jury's verdict as to WLJ. First, in examining what WLJ did to assist in the fraud, we determine that WLJ provided only legal services that "[constitute] the daily grist of the mill" of a law firm with a substantial

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24. We re-emphasize that WLJ's duty ran to its clients, not to the bondholders.

securities practice. *Woodward*, 522 F.2d at 97. Consequently, *Woodward* requires "clear proof of intent to violate the securities laws." *Id.* But at best, the evidence shows only that WLJ recklessly disregarded its duties to its clients. WLJ ignored several warning signs that the jury could have found aroused the law firm to suspect the propriety of the offering.

Aroused suspicions, however, do not constitute actual awareness of one's role in a fraudulent scheme. Moreover, to prove plainly that an alleged abettor intended to violate the securities laws, plaintiffs must prove more than that the abettor recklessly ignored danger signals.[25] Consequently, we conclude that the jury's verdict holding WLJ liable for securities fraud was not supported by the evidence, and we overturn that verdict.

## IV. *RICO*

The bondholders also claim that Fryar and All American violated the provisions of the Racketeering Influenced and Corrupt Organizations Act ("RICO").[26]

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25. We note that this analysis is the same whether we characterize "clear proof of intent" as the proof necessary to show knowledge or as the evidence necessary to establish commitment.

26. 18 U.S.C. §§ 1961-1968. The portions of RICO that are relevant to this appeal are:

§ 1961. *Definitions*
As used in [RICO]–
(1) "racketeering activity" means . . . (B) any act which is indictable under any of the following provisions of title 18,

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Specifically, they repeated the allegation that Fryar committed securities fraud and also charged these defendants with mail fraud and wire fraud. The jury believed the bondholders and found that Fryar's racketeering activity had caused $850,000 damage to the bondholders. The trial judge, who apparently assumed that these damages did not duplicate the securities damages, trebled the jury's figure and awarded the plaintiffs $2,550,000 on

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United States Code: . . . section 1341 (relating to mail fraud), section 1343 (relating to wire fraud), . . . or (D) any offense involving . . . fraud in the sale of securities. . . .

(5) "pattern of racketeering activity" requires at least two acts of racketeering activity, one of which occurred after the effective date of this chapter and the last of which occurred within ten years (excluding any period of imprisonment) after the commission of a prior act of racketeering activity.

§ 1962. *Prohibited activities*

(a) It shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity or through collection of an unlawful debt in which such person has participated as a principal within the meaning of section 2, title 18, United States Code, to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce. A purchase of securities on the open market for purposes of investment, and without the intention of controlling or participating in the control of the issuer, or of assisting another to do so, shall not be unlawful under this subsection if the securities of the issuer held by the purchaser, the members

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their RICO claims.[27] Fryar attacks this judgment on three grounds.

First, Fryar asserts that plaintiffs failed to prove any compensable damages. Title 18 U.S.C. § 1964(c) authorizes "[a]ny person injured in his business or property" to

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of his immediate family, and his or their accomplices in any pattern or racketeering activity or the collection of an unlawful debt after such purchase do not amount in the aggregate to one percent of the outstanding securities of any one class, and do not confer, either in law or in fact, the power to elect one or more directors of the issuer.

(b) It shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

(c) It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

(d) It shall be unlawful for any person to conspire to violate any of the provisions of subsections (a), (b), or (c) of this section.

§ 1964. *Civil remedies* . . .
(c) Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee.

27. The court was required under 18 U.S.C. § 1964(c) to treble the bondholders' damages. *See supra* n. 26.

sue based upon the injurious RICO violations. Fryar argues that the evidence did not establish (1) any injury to plaintiffs' business or property or (2) any causal connection between the plaintiffs' putative injuries and Fryar's misrepresentations.

We disagree. Plaintiffs proved, to the jury's satisfaction, that the Westside project was less feasible than Fryar had represented, and that Fryar misrepresented key facets of Westside's financial structure. Most significantly, Fryar withheld the details of his land transaction with All American, of All American's huge profit when it resold the same land to Westside, and of his $2 million pledge, of which money none came from his own pocket.

The bondholders also developed substantial evidence to support the jury's conclusion that Westside's rickety financial structure, long hidden by Fryar's financial tricks, caused its ultimate bankruptcy. In that bankruptcy, the court reduced the bond's interest rate by nearly one-third. This is a sufficient showing that Fryar's alleged RICO violations injured the bondholders' property.

Fryar also contends that RICO requires plaintiffs to prove at least two related predicate acts arising from distinct schemes. *See* 18 U.S.C. § 1962 (requiring a RICO plaintiff to prove a "pattern of racketeering"). Fryar's brief correctly notes that "[p]laintiffs have fashioned their RICO claim from the *matrix* of their *securities law fraud claims*." From this observation, Fryar concludes that the plaintiffs failed to prove the predicate acts necessary to establish a "pattern of racketeering."

Our cases, however, belie Fryar's legal analysis. In *R.A.G.S. Couture, Inc. v. Hyatt*, 774 F.2d 1350 (5th

Cir.1985), we held that RICO requires only that the predicate acts alleged be related, *not* that they arise from separate schemes or incidents. Here, plaintiffs have alleged over half a dozen acts of mail fraud and wire fraud, each of which stems from Westside's bond offer. *R.A.G.S.* requires no more. *But see Montesano v. Seafirst Commercial Corp.*, 818 F.2d 423, 426 (5th Cir.1987); *Crocker v. F.D.I.C.*, 826 F.2d 347, 348 n. 2 (5th Cir.1987), *cert. denied*, ___ U.S. ___, 108 S.Ct. 1075, 99 L.Ed.2d 235 (1988); *Smith v. Ayers*, 845 F.2d 1360, 1365-66 n. 18 (5th Cir.1988). (Each of these cases criticizes *R.A.G.S.*, but notes that only the court sitting *en banc* or the Supreme Court may overturn *R.A.G.S.*)[28]

Finally, Fryar argues that plaintiffs failed to prove any of their wire fraud or mail fraud allegations. Fryar reasons that mail fraud and wire fraud, which he assumes incorporate all the elements of fraud, must require plaintiffs to prove materiality and reliance. He asserts that the plaintiffs have failed to establish these two elements.

Materiality and reliance, however, are *not* elements of either wire fraud or mail fraud. Our cases unmistakably hold that plaintiffs need prove *only* a defendants' fraudulent intent; the success of a fraudulent scheme is not necessary to establish mail fraud or wire fraud. To prove mail fraud, for example, a plaintiff must prove that

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28. We recently granted a petition for a re-hearing *en banc* to address this issue. *Smith v. Cooper/T. Smith Corp.*, 850 F.2d 1086 (5th Cir.1988) (vacating panel op. at 846 F.2d 325 (5th Cir.1988)).

> (1) the defendant participated in some scheme or artifice to defraud, (2) the defendant or someone associated with the scheme used the mails or 'caused' the mails to be used, and (3) the use of the mails was for the purpose of executing the scheme.

*Armco Indus. Credit Corp. v. SLT Warehouse Co.*, 782 F.2d 475, 481-82 (5th Cir.1986) (citing *United States v. Davis*, 752 F.2d 963, 970 (5th Cir.1985)). A "scheme to defraud" is one "in which artifice or deceit is employed to obtain something of value. . . ." *United States v. Kreimer*, 609 F.2d 126, 128 (5th Cir.1980). Thus, plaintiffs prove that Fryar intended to defraud them where they can show that defendant's plan was "reasonably calculated to deceive persons of ordinary prudence and comprehension." *United States v. Finney*, 714 F.2d 420, 423 (5th Cir.1983).[29] Under RICO, each use of the mails to accomplish the same scheme is a separate predicate act. *See R.A.G.S.*

Here, plaintiffs alleged that Fryar had repeatedly used the mails to execute a scheme to sell Westside bonds with the intent of defrauding the purchasers. The record amply supports the jury's conclusion that Fryar, intending to defraud potential investors, devised and employed a scheme to sell Westside bonds. Fryar knowingly misled prospective bondholders about a land transaction that significantly affected Westside's financial structure. He

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29. *See also United States v. Toney*, 605 F.2d 200, 205 (5th Cir.1979), *cert. denied*, 444 U.S. 1090, 100 S.Ct. 1055, 62 L.Ed.2d 779 (1980); *United States v. Netterville*, 553 F.2d 903, 909 (5th Cir.1977), *cert. denied*, 434 U.S. 861, 98 S.Ct. 189, 54 L.Ed.2d 135 (1977) and 434 U.S. 1009, 98 S.Ct. 719, 54 L.Ed.2d 752 (1978).

falsely suggested that he had backed the health care project with $2,000,000 of his own money. Obviously, the jury could find that Fryar had a reasonably calculated plan to deceive persons of ordinary prudence and comprehension into giving Westside their money.

Nor does Fryar contest whether he used the mails repeatedly to execute this scheme; indeed, the evidence is overwhelming that he did. Fryar used the mails to obtain and transmit the application forms for Westside's certificate of need; to help create All American and interpose it in the transaction; and to send the land transaction documents to All American. He also caused others to use the mails to transmit the sales circulars that erroneously portrayed Fryar as purchasing and pledging $2,000,000 of bonds with his own money; and finally, he caused the mails to be used in an attempt to cover up the fraud and deceive bondholders into believing All American was performing more obligations than what it had actually undertaken.[30] Thus, the evidence strongly supports the jury's RICO verdict.

V. *State Law Claims.*

The bondholders also urge various state grounds for imposing substantive liability upon Fryar and WLJ. They

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30. We have stated that a person "need only have had a reasonable basis to foresee that his actions would result in the use of the mails" to be convicted of mail fraud. *United States v. Georgalis*, 631 F.2d 1199, 1206 (5th Cir. Unit B 1980). Here, Fryar had a reasonable basis to foresee that the underwriters and brokers would use the mails to sell the bonds and reassure the investors once the bonds were sold.

allege that defendants violated the Louisiana Blue Sky Law (LBSL) (La.R.S. 51:701 *et seq.*), negligently misrepresented and/or fraudulently misrepresented material facts (La.Civ.Code arts. 2315, 1953), committed fraud (La.Civ.Code art. 1953), and aided and abetted others in violating the law (La.Civ.Code art. 2324). The bondholders also claim that WLJ breached a fiduciary duty to them and committed legal malpractice. We now consider the merits of these claims.

A. *Louisiana Blue Sky Law.*

For exactly the same reasons that the defendants are not "sellers" under section 12, they are not "sellers" within the meaning of the LBSL. The LBSL was modeled after the federal Securities Act. *Caldwell v. Trans-Gulf Petroleum Corp.*, 322 So.2d 171, 174 (La.1975). The relevant language of the LBSL is virtually identical to the language of section 12.[31] Although there are no Louisiana

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31. The relevant language of the LBSL, as it existed throughout the period relevant to this appeal, reads:

> § 715 [of Title 51]. Civil liabilities
>
> A. Any person who . . . offers or sells a security in violation of [the LBSL] . . . is liable to the person buying the security from him. . . .
>
> B. Every person who directly or indirectly controls a seller liable under Subsection (A), every partner, officer, or director of such a seller, every person occupying a similar status or performing similar functions, every employee of such a seller who materially aids in the sale, and every broker-dealer or agent who materially aids in the sale are also liable jointly and severally with and to the same extent as the seller. . . .

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cases discussing "seller" status under the LBSL, in the absence of Louisiana authority, its state Louisiana courts interpret the LBSL in accordance with federal precedents. *Ek v. Nationwide Candy Division, Ltd.*, 403 So.2d 780, 785 (La.App.3d Cir.), *writ denied*, 407 So.2d 732 (La.1981).[32] Accordingly, the logic of the Supreme Court's *Pinter* decision is fully applicable to the LBSL.

B. *Negligent Misrepresentation; Fraudulent Misrepresentation.*

The bondholder plaintiffs assert several Louisiana claims based upon misrepresentation. Each of the misrepresentation claims plaintiffs allege – negligent misrepresentation and fraudulent misrepresentation – requires the plaintiffs to prove reliance.[33] Under Louisiana law,

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Neither WLJ nor Fryar was a controlling person, a broker-dealer, agent selling the bonds, or a partner, officer, or director of any organization that might be considered a "seller." Thus, § 715(B) does not apply to this case.

32. *Cf. Landry v. All Am. Assur.* Co., 688 F.2d 381 (5th Cir.1982) (applying federal tolling doctrine to LBSL in the absence of contrary Louisiana authority); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 551 & n. 27 (5th Cir. Unit A Mar. 1981), *rev'd in part on other grounds*, 459 U.S. 375, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983) (applying federal case law defining "seller" under the federal Securities Act to Texas blue sky statute in the absence of contrary Texas authority). Both the plaintiffs and WLJ have stated in briefs that the determination of "seller" status under the LBSL should be the same as the determination of "seller" status under § 12.

33. Negligent misrepresentation, according to Louisiana jurisprudence, is encompassed within the broad language of articles 2315 and 2316 of the Louisiana Civil Code. *Devore v. Hobart Mfg. Co.*, 367 So.2d 836, 839 (La.1979). To prevail on a

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reliance means *actual* reliance. *La Croix v. Recknagel*, 230 La. 842, 89 So.2d 363, 367 (La.1956); *Luquette v. Floyd*, 147 So.2d 894, 899 (La.App.1962), *writ denied*, 244 La. 119, 150 So.2d 585 (1963).

Here, the class has completely failed to prove that most of its individual members actually subjectively

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claim of negligent misrepresentation, the plaintiff must show that the defendant owed a legal duty to him to provide correct information, a breach of that duty, and resultant injury to the plaintiff. *Beal v. Lomas & Nettleton Co.*, 410 So.2d 318, 321 (La.App. 4th Cir.1982); *Josephs v. Austin*, 420 So.2d 1181, 1185 (La.App. 5th Cir.1982), *writ denied*, 427 So.2d 870 (La.1983). In analyzing claims of negligent misrepresentation, Louisiana courts have referred to the Restatement (Second) of Torts. *Dousson v. S. Cent. Bell*, 429 So.2d 466, 468 (La.App. 4th Cir.), *writ not considered*, 437 So.2d 1135 (La.1983). *See also Silver v. Nelson*, 610 F.Supp. 505, 521 (E.D.La.1985).

Specifically, Louisiana courts have adopted the definition of negligent misrepresentation set forth in the Restatement (Second) of Torts § 552, which states,

> (1) One who, in the course of his business, profession or employment or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable *reliance* upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information. [Emphasis added.]

In general, the elements of a claim of fraudulent misrepresentation or fraud may be stated as follows: (1) a misrepresentation of a material fact, (2) made with the intent to deceive, and (3) causing justifiable reliance with resultant injury. *See* La.Civ.Code arts. 1847, 2315; *see also Silver v. Nelson.*

relied upon any misrepresentations. Only Abell and Walton established that they relied upon anything Fryar represented to be true, and neither of these two plaintiffs showed that he relied at all upon WLJ.

Moreover, the trial court ruled that any damages awarded under these claims would duplicate damages awarded under rule 10b-5. Since we agree and have held already that Fryar is liable to Abell and Walton for violating rule 10b-5, we defer further discussion of these claims to our discussion of the appropriate damages.

### C. *Legal Malpractice.*

As we describe above, the law traditionally has allowed only clients or former clients to state malpractice claims against attorneys. Here, we see this principle applied: The bondholders seek to hold WLJ liable *to them* for malpractice in the work WLJ prepared *for the underwriters*. Under Louisiana law, the bondholders ordinarily may maintain such an action only where the lawyer prepares an opinion for the benefit of the non-client plaintiff and knows the third party will rely upon that opinion.[34]

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34. Non-clients may also sue attorneys, who are the agents of their clients, for actions that exceed the scope of authority given by the clients. *Sondes v. Sears, Roebuck & Co.*, 501 So.2d 829 (4th La.App.1986). Such actions follow the law regarding third-party complaints against agents who exceed their authority. Since the bondholders do not allege that WLJ overstepped its bounds as an agent for the underwriters, we need not consider such a complaint here.

This test for attorney liability to non-clients was developed first in *Capital Bank & Trust Co. v. Core*, 343 So.2d 284 (1st La.App.), *writ denied*, 345 So.2d 61 (La.) and 345 So.2d 504 (La.1977). Core, an attorney, issued Capital a title opinion covering the property described in the collateral mortgage, knowing that Capital would rely thereon in making the loan to Core's client and also knowing the loan would not be made unless his client owned the mortgaged property in full ownership and free of all encumbrances except the collateral mortgage to Capital. Core's title opinion certified his examination of title to a stated date and hour as of which time Core found the mortgaged property was owned by his client free of all encumbrances save the collateral mortgage to Capital. Notwithstanding Core's title opinion, the mortgaged property was burdened with severe defects and encumbrances. Despite Core's knowledge that these statements were false, "he consciously and deliberately *certified* the truth and accuracy of his opinion." 343 So.2d at 289.

The appellate court held the attorney liable to the bank, reasoning that where an attorney furnishes a title opinion to a non-client knowing the third party would rely upon the opinion, the attorney is liable to the third party. *Id.* at 288. Significantly, the court grounded its decision in the codal provision that establishes liability for a stipulation *pour autrui* pursuant to which one may bind himself for the benefit of a third party. In such cases, privity of contract results, and the agreement becomes binding and effective in favor of the third party upon his acceptance. *Id;* La.Civ.Code art. 1890.

Another Louisiana appellate court has held that attorney liability to third parties does not extend beyond the *Capital Bank* rule. In *Clause v. Manuel*, 442 So.2d 905 (3d La.App.1983), *writ denied*, 448 So.2d 106 (La.1984), the court refused to hold a land purchaser's attorney liable to the vendor for a negligent title opinion the attorney prepared. The purchaser bought the property after his attorney issued a title opinion assuring the purchaser (and his financing bank) that the title was clear. Two and one-half years after the transaction, the purchaser discovered a tax lien the vendor had failed to pay. The purchaser sued the vendor, who then brought a third-party complaint against the attorney. The vendor, claiming she would have insisted on a higher price had she known of the encumbrance, sought indemnification from the lawyer.

The court affirmed summary judgment on the third-party complaint. It noted that the vendor had never retained the attorney, and that the lawyer did not advise her. As the *Clause* court wrote, "To render [the attorney] liable . . . , we would have to find that his title examination and title opinion were rendered for the benefit of [the vendor]." 442 So.2d at 908.

We emphasize that this rule, which we consider eminently sound, does not reduce attorneys' responsibility for their work, but merely prevents attorneys from dividing their loyalties between clients and non-clients. More recent cases reveal that Louisiana courts are concerned acutely about the ethical problems of confidentiality and loyalty that are exposed when the law requires attorneys to reveal information to non-clients.

The Louisiana Supreme Court recently ruled that a client does not have a malpractice claim against its own attorney for failing to reveal confidential information unless the client explicitly orders the disclosure. *Rayne State Bank & Trust Co. v. Nat. Union Fire Ins. Co.*, 483 So.2d 987, 992 (La.1986). The importance of preserving client confidences is even more vividly highlighted in *Scaccia v. Lowe*, 445 So.2d 1324 (La.App. 4 Cir.1984). There, the court refused to hold attorneys for a divorced woman liable to her former husband when they refused to tell him where she had hidden his minor child.

These cases underscore how basic attorney-client confidence and loyalty is to the American justice system. To protect those values, Louisiana allows third-party suits only if the attorney prepares an opinion for the non-client on which he knows the non-client will rely. Thus, the attorneys, who are always responsible to their clients and to the bar and the courts for their professional actions, may control when they assume a duty to third parties for their legal opinions.

This rule is identical to the one we formulate today to govern the liability of underwriter's counsel to investors who purchase the underwritten securities. We hold that the bondholders have failed to state a malpractice claim against WLJ.

D. *Fiduciary Duty.*

The bondholders also assert that WLJ breached a fiduciary duty it owed to them. We cannot find any Louisiana statute or case upon which plaintiffs base their claim, and they refer us to none. We assume, therefore,

that their claim is grounded in the general delictual principles of Civil Code articles 2315 and 2316 and of the Restatement (Second) of Torts. In particular, section 552 of the Restatement provides in relevant part:

> (3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

We hold that the Restatement provision, assuming it is part of Louisiana law, does not apply here. Bondholders do not suggest any public duty which WLJ has violated. As we have shown, WLJ had no attorney-client relationship with any of the bondholders and did not issue a signed legal opinion to the plaintiffs. Moreover, we cannot find any specific duty to the public which the securities laws impose upon attorneys. "Neither lawyers nor accountants are required to tattle on their clients in the absence of some duty to disclose. To the contrary, attorneys have privileges not to disclose." *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 497 (7th Cir.1986) (citations omitted). Consequently, WLJ had no fiduciary duty to breach.

### E. *Aiding and Abetting.*

At the time Westside offered its bonds to the public, Louisiana had a single statute that provided the basis for most vicarious or inchoate liability under Louisiana law. In 1982, that statute, Article 2324 of the Louisiana Civil Code, read in relevant part:

> He who causes another person to do an unlawful act, or assists or encourages in the commission of it, is

> answerable, *in solido*, with that person, for the damage caused by such act.[35]

The bondholders argue that WLJ is liable under this section for having aided Swink (and Fryar) in defrauding the investors who bought up Westside's bond offering.

In deciding this issue, as in deciding whether to impose rule 10b-5 liability upon someone who helps another to violate that rule, we focus primarily upon the element of scienter. Article 2324 does not specify the answer to this question, but several cases have analyzed it.

*Equilease Corp. v. Smith Int'l, Inc.*, 588 F.2d 919 (5th Cir.1979), is the leading case in our circuit discussing what level of scienter satisfies article 2324. There, a middleman who bought drill pipe for oil and gas exploration and then leased the pipe to oil explorers found itself threatened with bankruptcy. The middleman's primary creditor was the drill pipe manufacturer who had sold it. The middleman conspired with a financing company to defraud one of the financer's clients, a venture capitalist, of funds the middleman desperately needed to remain afloat. To that end, the middleman and financer forged several of the manufacturer's documents, including pipe invoices, to convince the venture capitalist that the middleman owned more assets than he actually did. The venture capitalist, relying upon the forged documents, loaned the middleman the needed funds.

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35. Louisiana has since amended article 2324 (in 1987), and it no longer contains this language.

At the same time, the manufacturer began pressing the middleman hard to make good on some late payments. Worried that the manufacturer would put it in default, the middleman called the financer, who had possession of the venture capitalist's checks, and ordered the financer to expedite its paperwork. In its rush, the financer sent the manufacturer a suspiciously large check, and accidentally included one of the forged invoices.

The manufacturer thought the size of the check peculiar, but did not catch the forgery in the invoice until after it had cashed the check. Once it did catch the forgery, it called the financer, whom the manufacturer thought had originated the new loan to the middleman. (The venture capitalist wished its efforts to remain anonymous, and thus allowed the financer to take all public actions for the venture capitalist.) Naturally, the financer, whose part in the fraud the manufacturer had no reason to suspect, reassured the puzzled manufacturer that all was well. The manufacturer did nothing else, and the venture capitalist did not discover the fraud itself until the bankrupt middleman was no longer able to return the purloined money.

In *Equilease*, the plaintiff venture capitalist argued that the defendant manufacturer, who had no knowledge of the fraud it purportedly had assisted, was liable under a theory of negligence. The venture capitalist suggested two theories to support the proposition that a negligent defendant could be liable for assisting in fraud, which requires knowledge. First, according to the venture capitalist, Louisiana employs a theory of "negligent ignorance" that requires someone who should suspect fraud

to investigate and act to thwart the fraud. We agreed with the venture capitalist that

> [i]n certain situations Louisiana courts have recognized the common law principle, often styling it 'negligent ignorance', that knowledge of the results of a proper investigation can be imputed to a person who has actual knowledge of elemental facts, yet fails to inquire into their significance.

*Id.* at 926.

Nonetheless, we reviewed the confused case law of Louisiana and concluded that Louisiana utilizes this tort theory primarily in real property title suits. In such cases, land investors who should have suspected title defects, but failed to investigate, were estopped where the rightful owners sued to regain title. We declined to extend the doctrine of "negligent ignorance" to hold negligent abettors liable for fraud:

> Knowledge is imputed in these [real property] cases to estop the defendant from taking inequitable advantage of a predicament caused by his own failure to investigate. We are not concerned here with preventing the defendant from obtaining an unfair advantage of his own but with imposing a further obligation on the defendant to compensate the victim of fraud for the loss he sustained. Moreover, the predicament of the plaintiff was not caused by the direct action of the defendant since he was not originally a party to the fraudulent transaction. Rather, the defendant's relationship to the plaintiff arises only from the fact that he may have been able to prevent the predicament had he investigated the possibility that he was assisting a fraud.

*Id.* at 927-28 (footnote omitted).

We then turned to the venture capitalist's theory that an abettor, like a joint tortfeasor, may be held liable under Louisiana law for negligently assisting and intentionally inflicting harm. We held:

> Logically, a party may be held individually liable for negligence whether the damage caused to the plaintiff takes the form of fraud or bodily injury. And we perceive no impediment to binding a defendant who acts negligently *in solido* with those who commit an intentional tort when the same harm to the plaintiff results, provided, of course, that each party is legally at fault.

*Id.* at 929 (footnotes omitted).

The bondholders argue that *Equilease* applies here. We agree, but hold WLJ not liable. To be "legally at fault," one must owe a duty to the person harmed. In *Equilease*, we held that the manufacturer had not acted negligently because the manufacturer had no knowledge of the venture capitalist's existence and no concrete evidence of unlawful activity in light of the financer's assurances. We concluded that the manufacturer owed the venture capitalist no further duty to investigate. Similarly, we have already held that WLJ owed no duty to the bondholders to disclose client confidences which WLJ had a duty to keep.[36]

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36. *Bank of New Orleans & Trust Co. v. Monco Agency, Inc.*, 823 F.2d 888 (5th Cir.1987), *cert. denied*, ___ U.S. ___, 108 S.Ct. 1019, 98 L.Ed.2d 984 (1988), is inapposite because that case only reversed a summary judgment in favor of accountants which had held a bank's claim to be time barred. The issue of accountant's duties to nonclient third parties (such as the bank) was not raised or decided by that appeal.

We come to the same conclusion when we examine the single relevant Louisiana case decided since *Equilease*. In *Summers Brothers v. Brewer*, 420 So.2d 197 (1st La.App.1982), the perpetrator of a fraudulent scheme to raise funds for a non-existent business succeeded because he had forged a maintenance contract and obtained unauthorized stock in another company. Both documents impressed the businessmen he had targeted for the fraud, and convinced them that the non-existent business was real. The maintenance contract was notarized by an attorney who did not witness anyone signing the document, and thus did not know it had been forged. Similarly, the schemer got the "issuing" company's attorney, who knew the perpetrator was a felon, to sign the unauthorized stock certificates.

The appellate court held that article 2324 did not impose liability upon either lawyer. The court determined that the attorneys' actions

> were independent acts, with the fraudulent scheme . . . already set in motion before [the lawyers] participated in the fraud. Furthermore, some of the damages caused to plaintiffs by [the attorneys] were not the natural and foreseeable consequences of the earlier fraudulent acts of [the perpetrator], but were rather the result of particular wrongdoing or fault on the part of [the lawyers]. . . .

420 So.2d at 204. Thus, where the assistance rendered is comprised of actions that do not involve the abettor directly in the fraud, article 2324 does not apply. This conclusion is reinforced if the assistance itself creates a harm unique and independent from any harm foreseeable from the original fraud.

*Summers Brothers* appears to vitiate *Equilease's* teaching that a negligent tortfeasor may be independently liable for another's fraud where the negligence is independent of the fraud and compounds the fraud's harm. However, negligent tortfeasors whose acts are not independent of the fraud still must owe a duty to those whom the fraud harms; otherwise, the fraud victims may not prevail against the negligent actor. Here, WLJ owes no such duty.

## VI. *Damages.*

Both sides also raise a variety of damages issues touching on virtually every aspect of the lawsuit. We turn now to the damages findings of the jury and the damages awarded by the court.[37]

### A. *Rule 10b-5 Damages.*

The jury found that the plaintiffs suffered $9,549,000 in lost Westside bond interest payments because of defendants' fraud,[38] but refused to award plaintiffs any out-of-

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37. Since we decide all liability issues favorably to WLJ, the damage issues apply now only to Fryar. Of course, certain of the arguments as to damages were presented by WLJ.

38. Since the jury found that the defendants who had already settled were 30% responsible for the securities fraud, the court awarded only 70% of $9,554,000 (or $6,715,800) against the defendants who stood trial.

pocket damages. The jury also found that the Cheneyville land transaction, in which All American received $2,000,000 worth of Westside bonds that later entitled it to substantial interest payments, unjustly increased All American's wealth by $2,950,000. The defendants attack this award on two grounds, and the plaintiffs attack it on one ground of their own.

First, the defendants argue that the evidence of damages which the plaintiffs presented was too vague and flawed to support any specific damages award. Since we have overturned the judgment in favor of the class as a whole, these damages must be redetermined, in any event.

Second, and more fundamentally, the defendants contend that rule 10b-5 plaintiffs may collect only out-of-pocket damages, which the jury found the plaintiffs had not suffered. Defendants also argue that plaintiffs are entitled to only one award under rule 10b-5,[39] and that

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39. Section 28(a) of the Exchange Act, upon which defendants rely in arguing that the plaintiffs received an impermissible double recovery, reads in relevant part:

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

15 U.S.C. § 78bb(a).

the award for lost interest should be affirmed only to the extent it exceeds the $2,950,000 windfall profit which All American must repay to the bondholders.

Before we consider this challenge, however, we will examine Abell and Walton's response. They counterattack the jury's determination that the plaintiffs suffered no out-of-pocket damages, claiming that the evidence does not support such a verdict.

We do not agree with plaintiffs that the jury should have found that the bondholders suffered some out-of-pocket damages. Such out-of-pocket damages, the traditional measure of damages in a rule 10b-5 action, are "the difference between the real value of [the securities at issue] and the amount paid by the plaintiffs *at the time of purchase.*" *James v. Meinke*, 778 F.2d 200, 205 (5th Cir.1985) (emphasis added). Here, measured at the time of purchase, the jury could find that the bondholders paid only what the bonds were worth. The market price for Westside bonds did not fluctuate much in the first few years after Westside issued them. Even after Westside revealed, in a letter dated January 20, 1983, the information that previously had been withheld, prices for Westside bonds remained stable.

Indeed, plaintiffs did not sustain any actual losses until Westside defaulted on an interest payment in October 1984, more than three months after filing this suit. After that default, the bonds temporarily lost much of their face value, but rebounded to about par value after the bankruptcy court allowed Westside to reduce the interest rate which each of the bonds bore. Consequently, few of the Westside bondholders lost any money out of

their own pockets, and none who paid the face value of the bonds at any time before October 1984 paid more than the bonds were worth.

Defendants aggressively contend that rule 10b-5 awards damages only for out-of-pocket losses. They argue that we adopted this rule in *Huddleston*. As defendants note, *Huddleston* observed that "the out-of-pocket rule . . . is the traditional measure of damages in a rule 10b-5 action. . . ." 640 F.2d at 555. We noted that out-of-pocket losses, properly calculated, measure how much the defendants' fraud inflates the value of the subject securities. The out-of-pocket rule thus distinguishes between losses caused by the defendants' fraud and losses caused otherwise (e.g., by market forces). *Id.* Consequently, this rule ordinarily is the correct measure of rule 10b-5 damages.

"The ultimate question, however, is how much damages did the defendants' fraudulent misstatement or omission cause each individual plaintiff?" *Id.* at 554. The Supreme Court has approvingly noted that various other measures of damages can be used in section 10b-5 cases where out-of-pocket damages provide an inadequate measure. *Randall v. Loftsgaarden*, 478 U.S. 647, 663, 106 S.Ct. 3143, 3153, 92 L.Ed.2d 525 (1986). Since *Huddleston*, we have applied yardsticks other than the out-of-pocket measurement where appropriate. *See James v. Meinke* (imposing consequential damages where jury found no out-of-pocket damages).

In this instance, the plaintiffs argue, the out-of-pocket rule does not accurately measure their losses. Here, the initial value of the possessory interest in the

bonds was equal to the par value of those bonds; the bondholders did not suffer any losses until Westside went bankrupt and eventually reorganized. With reorganization, the interest rates which the bonds bore dropped to about two-thirds of the original rates. The decrease in the interest rates naturally reduced the value of the possessory interest from what it would have been otherwise.[40]

Since the fraudulently-concealed details of the Westside land transaction and Fryar's shaky guarantee to support Westside financially caused Westside's bankruptcy, the defendants' fraud caused the bondholders to sustain two types of property loss: the loss of a reasonably certain, legally guaranteed stream of income, and the resulting loss of some of the resale value of the bonds. The former is not a loss which the out-of-pocket rule can measure.

We agree with bondholders, therefore, that rule 10b-5 may compensate them for the loss of a contracted right to a guaranteed stream of income. The right to receive a specified stream of income is a property right distinguishable from possessory interests in the bonds themselves. The possessory interest allows the purchaser to hold or dispose of the bonds as the purchaser sees fit and entitles the holder to enjoy any subsidiary interests,

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40. The defendants, noting that the bonds still trade close to par value, argue that the bondholders' possessory interest did not shrink because of Westside's bankruptcy. This argument, however, misses the mark; Westside bonds presumably would be trading at significantly *above* par value had Westside continued to pay the original interest rates.

including the right to receive any income stream which the bond pays, that have not been alienated from the possessory interest itself.

The right to receive income-stream payments (or, in the case of bonds, interest payments) is a distinct interest that is subsidiary to the purchaser's possessory interest. As a landowner may sever subordinate mineral rights, so may a bondholder sever the distinct right to income payments (the coupons) from the bond itself.[41] Consequently, an investor purchasing a bond acquires at least two separate property interests vulnerable to the destructive fraud of another.

Were we to adopt the defendants' position that *only* out-of-pocket damages are available, we would effectively limit rule 10b-5 plaintiffs to damages to their possessory interests only – the price paid for the security minus its real value at the time of purchase. Thus, plaintiffs would be unable to collect all the actual damages which the fraud ultimately causes.

Here, since the plaintiffs also acquired a right to future interest payments, the damage award must reflect the interest payments plaintiffs lost because of defendants' fraud. Since the fraud, like a cancer, began its destructive course from the time of purchase, we measure the damage to the right to an income stream according to

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41. The classic example of a bondholder who alienates the interest payments from the possessory interest is one who sets up a trust arrangement (assuming the cestui has a legal right to the interest payments as well as an equitable right).

a formula similar to our out-of-pocket damage calculation: Plaintiffs are entitled to the difference, discounted to present value at the time of purchase, between the stream of income as represented and the income stream remaining after the fraud has worked its course.

Unfortunately, the expert who calculated and explained to the jury the interest payments which the bondholders had lost discounted the value of those payments to their present value *at the time of trial*. These calculations, which were the only damages figures upon which the jury could base its verdict, must be recomputed to determine their present value *at the time the bonds were purchased*. We therefore remand for the district court to recalculate Abell's and Walton's lost interest payments.

On remand, we instruct the district court not to recompute how the lost interest payments reduced the bondholders' possessory interest. We measure the damage done to possessory interests by the out-of-pocket rule only. Since the jury found no out-of-pocket damages, the plaintiffs are not entitled to any compensation for lost value.[42]

The defendants forcefully urge us to instruct the district court to reduce the rule 10b-5 award by the amount of interest income which the bondholders earned

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42. In fact, the expert proved only that the fraud reduced the value of the bonds *to* par value. Consequently, the fraud only reduced the profit which investors could have made from Westside bonds; it did not reduce the bonds' value to less than what the bondholders paid for them.

before Westside defaulted on interest payments. The defendants note that the Supreme Court, in *Randall*, held that rule 10b-5 damage awards ordinarily should reflect the actual damages which the plaintiffs incur. Since the income a bondholder receives from a bond reduces that bondholder's actual damages, income should be deducted from the damage award. The defendants claim that the interest payments here are such income, relying upon cases requiring courts to reduce damages by the *dividend* income earned on subject securities.

We conclude, however, that *Randall* is inapposite. Here, plaintiffs claim injury to their right to receive specified contractually-set interest payments. They had an established property right to receive an invariable stream of income at specified moments over a pre-determined contractual period.[43] Plaintiffs claimed, and proved, that Fryar, All American, and others fraudulently undermined their rights to future interest payments. It hardly makes sense, in determining what amount of damages will make plaintiffs whole again, to reduce the award by the interest payments which plaintiffs received in the past. Such a result would "make whole" only those plaintiffs who agreed to forsake part of what defendants had not destroyed to regain what defendants had destroyed.

Nor do we think that our rule today conflicts with existing law. *Randall*, for instance, recognized that courts must reduce *section 12* damage awards by the income

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43. That the terms of any given bond might differ dramatically from the terms of any other bond is of no consequence, since the terms of each bond were unambiguously established.

which a section 12 plaintiff receives from owning the subject security. In this case, where we must decide what damages will compensate a rule 10b-5 plaintiff, *Randall* directs us to determine the "actual damages" which the plaintiff has incurred. Were we considering the damage done to plaintiffs' possessory interest in the bonds, we would have to offset any award by the income which that possessory interest had reaped for its owners. Here, however, the property interest damaged was a right to receive a specific stream of income; offsetting such a damage award by income received under the bond agreements makes little sense.

The defendants make one final attack upon the damage award. They argue that if the plaintiffs collect both the $2,950,000 All American must pay for unjust enrichment *and* all of plaintiffs' lost interest income, the plaintiffs will receive an unjust double recovery. We agree, and direct the district court on remand to award only the lost interest that exceeds what All American must pay for unjust enrichment.

Section 28(a) of the Exchange Act limits rule 10b-5 plaintiffs to *actual damages*. *Randall*, 478 U.S. at 662. Rule 10b-5 exists primarily to compensate victims and secondarily to deter securities defrauders; as long as the award necessary to compensate victims is enough to deter wrongdoers, we would not award additional deterrent damages. We award such deterrent damages, including damages for unjust enrichment, only when compensatory damages allow the wrongdoers to profit from their fraud. Of course, when we award deterrent damages, they *always* exceed or equal compensatory damages, and thus it is not necessary to award additional, duplicative "compensatory" damages.

Succinctly put, section 28(a)'s actual-damage rule ordinarily requires us to award plaintiffs only what they actually lost. But "where the defendant received more than the [plaintiffs'] actual loss . . . damages are the amount of the defendant's profit." *Affiliated Ute*, 406 U.S. at 155, 92 S.Ct. at 1473. In any event, we *never* award plaintiffs both their actual loss and the defendant's unjust enrichment, because that would amount to an impermissible double recovery. "[T]he accepted rationale underlying this *alternative* is simply that '[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.' " *Randall*, 478 U.S. at 663, 106 S.Ct. at 3153 (emphasis added) (quoting *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879, 86 S.Ct. 163, 15 L.Ed.2d 120 (1965)).

B. *RICO Damages.*

1. *Sufficiency of the Evidence.*

Fryar argues that the RICO damages assessed against him and All American (1) should be overturned because Fryar and All American did nothing to harm the bondholders' business and property interests, or, alternatively, (2) should be reduced by one-third, because the compensatory portion of the RICO award duplicates the securities-fraud damages.

We reject Fryar's first argument because, as we have already shown, Fryar and All American's securities fraud substantially harmed the plaintiffs' right to future interest payments. As Fryar himself concedes, the plaintiffs base their securities fraud claim upon the same factual allegations as those supporting their mail-fraud RICO

claims against Fryar. Since reliance is not an element of the class's RICO claims, it follows that the proof of its damages which the class presented suffices to show that Fryar and All American caused measurable RICO damages against the class members.

Fryar contends that the plaintiffs presented only flawed and inadequate evidence to quantify their damages. The crux of Fryar's argument is that the expert testimony which the plaintiffs used to establish damages was based upon faulty assumptions and questionable data. The data consisted of questionnaires, some not completed, which some of the Westside bondholders had answered. The bondholders who returned their questionnaires included people who were not members of the plaintiff class and people who did not buy their bonds from any defendants named in plaintiff's complaint.

Fryar also attacks the expert's calculations based upon this data: Fryar argues that the expert failed to adjust his calculations to account for class members who had sold their bonds, for bondholders who had bought Westside bonds *after* Westside's bankruptcy, and for the interest income the bondholders earned before Westside went bankrupt. Finally, Fryar argues that the jury verdict does not reduce the plaintiffs' damages to reflect causes other than fraud that contributed to plaintiffs' lost interest income.

We reject Fryar's arguments. Albert Derbes, the plaintiffs' damages expert, calculated that the class had lost $8,616,973 in future interest payments discounted to

present value at the time of trial.[44] Derbes explained that accounting experts such as himself customarily rely upon questionnaires, similar to the one which Fryar attacks, to compute such lost interest payments. Second, the class does *not* include persons who purchased Westside bonds after it defaulted on its interest payments, and thus Derbes's calculations (of the class's losses) do not include such bondholders. Neither do we do agree that the jury verdict fails to reduce the award to account for other causes that contributed to plaintiff's losses. Since the jury awarded plaintiffs considerably less than the damages which they proved at trial, we assume the jury adequately accounted for any additional causes of plaintiffs' damages.

### 2. *Duplication of RICO and Securities Damages.*

The defendants argue that the potential securities fraud award under rule 10b-5 should be reduced by the RICO award against Fryar and All American. They contend that RICO is primarily remedial, and that its treble damages should be considered compensatory relief and thus subject to the single-recovery rule. In defendants' view, we should apply section 28 of the Exchange Act to reduce rule 10b-5 damages to account for the compensation which the plaintiffs obtain under RICO.[45]

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44. Plaintiffs also introduced evidence that after Westside defaulted on its interest payments in October 1984, the class lost, as of the date of trial, an additional $3,402,146.60 in past-due interest payments.

45. Of course, in light of our exoneration of WLJ on liability, this damage issue now can affect recovery only against Fryar.

We are not directed, however, to any of our cases that address the nature of RICO in this regard. After conducting our own search of applicable authorities, we have concluded that none of our sister circuits has considered this question either. We acknowledge that several district courts have expounded learnedly on how to characterize RICO damages,[46] but there are no extant opinions that bind us today. We write, therefore, on an essentially clean slate.

At least a portion of the RICO damages should be deemed remedial. Civil damages under RICO are available only to those persons "injured in [their] business or property by reason of a [RICO] violation. . . ." 18 U.S.C. § 1964(c). Congress directed the courts that RICO as a whole "shall be liberally construed to effectuate its remedial purposes." 84 Stat. 947, 18 U.S.C. § 1961 note.

Here, whatever portion of RICO relief is remedial duplicates the damages awarded under rule 10b-5. The evidence fails to show that the defendants caused any harm to plaintiffs' business or property other than to reduce their interest income from Westside bonds. As we

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46. *Compare State Farm Fire & Cas. Co. v. Estate of Caton*, 540 F.Supp. 673, 680 (N.D. Ind.1982); *In re Nat'l Mortg. Equity Corp. Mortg. Pool Certificates Sec. Litig.*, 636 F.Supp. 1138 (C.D. Cal.1986) (holding that all RICO damages are compensatory) *with Summers v. FDIC*, 592 F.Supp. 1240 (W.D. Okla.1984) (holding that the trebled portion of RICO damages is penal).

have already discussed, the individual plaintiffs are entitled to recover from All American all the unjust enrichment which All American gained from Westside. Thus, we must adjust Abell's and Walton's damage claims. Since All American's gains (valued by the jury at $2,950,000) exceed the RICO damages ($2,550,000), the only question is: How much of the RICO award is compensatory and thus duplicative of rule 10b-5 relief?

The answer to this question turns on the nature of treble damages under RICO. Congress provided, in 18 U.S.C. § 1964(c), that RICO plaintiffs are entitled to treble proven damages and a reasonable attorneys' fee. We must determine whether the trebling feature of section 1964(c) damages is penal or remedial. If remedial, treble damages are entirely compensatory, and the rule 10b-5 award must be reduced by the entire amount of the RICO award attributable to Abell and Walton. If RICO's trebling formula is penal, then only one-third of the RICO damages are compensatory, and the securities fraud damages are to be reduced by one-third of Abell's and Walton's RICO recoveries.

Courts faced with the task of determining whether a statute is penal in nature need not venture upon uncharted seas, for the standard of analysis has been defined since the case of *Huntington v. Attrill*, 146 U.S. 657, 668-69, 13 S.Ct. 224, 228, 36 L.Ed. 1123 (1892):

> The test whether a law is penal, in the strict and primary sense, is whether the wrong sought to be redressed is a wrong to the public, or a wrong to the individual, according to the familiar classification of Blackstone: 'Wrongs are divisible into two sorts or species: *private wrongs* and *public wrongs*. The former are an infringement or privation of the private or

> civil rights belonging to individuals, considered as individuals; and are thereupon frequently termed *civil injuries:* the latter are a breach and violation of public rights and duties, which affect the whole community, considered as a community; and are distinguished by the harsher appellation of *crimes* and *misdemeanors.*' [Emphasis in original.]

On the basis of the Supreme Court's opinion and its progeny, the Sixth Circuit in *Murphy v. Household Fin. Corp.*, 560 F.2d 206, 209 (6th Cir.1977), distilled three factors to be used in determining whether the statute is penal: (1) whether the purpose of the statue is to redress individual wrongs or more general wrongs to the public; (2) whether the recovery under the statute runs to the harmed individual or to the public; and (3) whether the recovery authorized by the statute is wholly disproportionate to the harm suffered.

We have never adopted the Sixth Circuit test, but have instead accepted it as a useful tool in interpreting *Huntington. Cf. First Nat'l Bank & Trust Co. v. Flatau,* 643 F.2d 188, 191 (5th Cir.1980). In that vein, we note the following passage from *Huntington:*

> In the municipal law of England and America, the words 'penal' and 'penalty' have been used in various senses. Strictly and primarily, they denote punishment, whether corporal or pecuniary, imposed and enforced by the State, for a crime or offense against its laws. [Citations omitted.] But they are also commonly used as including any extraordinary liability to which the law subjects a wrongdoer in favor of the person wronged, *not limited to the damages suffered.*

146 U.S. at 666-67, 13 S.Ct. at 227 (emphasis added) (as quoted in *First Nat'l Bank & Trust Co. v. Flatau*, 643 F.2d at 190).

We hold that the portion of RICO damages in excess of actual damages is penal. Those added damages are "not limited to the damages suffered"; they seem more designed to deter than to compensate. As Congress constructed them, the civil provisions of RICO compensate primarily victims of fraud or fraudulent schemes. Had Congress merely wanted to make whole this new class of plaintiffs, it would have limited civil RICO damages to the actual damages commonly available to fraud victims.

However, in promulgating RICO, Congress expressly found that the problem of racketeering was primarily public, not private, including draining resources from the economy, subverting the democratic process, and undermining the general welfare. 84 Stat. 922-23 (1970) (findings and purpose of the Organized Crime Control Act of 1970, Title IX of which is RICO). *See also Summers*, 592 F.Supp. at 1242. We conclude, therefore, that Congress trebled RICO damages as part of this overall attack on the public wrongs of organized crime.[47]

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47. Our result would be the same had we applied the *Murphy* three-pronged test. First, although the purpose of § 1964(c) is to redress both public and private wrongs, the trebling component of that provision appears to be aimed primarily at remedying public wrongs. Second, recovery under § 1964(c) obviously runs to the individual, a factor suggesting the statute is *not* penal. But finally, the authorized penalty is plainly disproportionate to the individual harm

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C. *Attorneys' Fees.*

The district court, after an extensive hearing, awarded $2,567,323.30 in attorneys' fees. In spite of the "American rule" that attorneys' fees shall be awarded as a matter of course only when a specific statute so authorizes, the court failed to indicate the basis for its decision. The defendants challenge this award.

WLJ contends that it is not substantively liable for violating any statute upon which the court may have based attorneys' fees. Since we have absolved WLJ of all liability, we agree and reverse the district court's judgment insofar as it holds WLJ and its insurer (Valley Forge) liable for attorneys' fees.

Fryar also argues that the district court should have assessed only those attorneys' fees necessary to develop the claims for which attorneys' fees may be awarded. He notes, correctly, that attorneys' fees are not available as a matter of course under rule 10b-5. *Huddleston*, 640 F.2d at 559. Fryar argues that work done on the securities claims, under which plaintiffs may not receive attorneys' fees, undoubtedly consumed most of the legal resources which the plaintiffs spent on this case. Consequently, Fryar's position, should we adopt it as our own, would dramatically reduce the attorneys' fees to which plaintiffs are entitled.

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redressed, since it is trebled. *See Texas Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 639, 101 S.Ct. 2061, 2066, 68 L.Ed.2d 500 (1981) ("The very idea of treble damages reveals an intent to punish past, and to deter future, unlawful conduct, not to ameliorate the liability of wrongdoers.").

We note first that Fryar's argument presents a case of first impression. Of the statutes upon which the plaintiffs based their claims, only RICO and the Louisiana fraud statutes allow a court to award attorneys' fees as a matter of right. We have not been directed to any cases interpreting these statutes in regard to the attorneys' fees issue presented here.

We choose to adhere to a rule slightly different from the one which Fryar proposes. We think it best to apply the rule we have fashioned for awarding attorneys' fees in other areas of the law. Where plaintiffs base several claims, derived "from related legal theories," upon "a common core of facts," we allow attorneys' fees for the work done on all such related claims. *Hernandez v. Hill Country Telephone Coop., Inc.*, 849 F.2d 139, 144 (5th Cir.1988) (citing *Hensley v. Eckerhart*, 461 U.S. 424, 435, 103 S.Ct. 1933, 1940, 76 L.Ed.2d 40 (1983)); *Espino v. Besteiro*, 708 F.2d 1002, 1007-10 (5th Cir.1983). As Fryar himself concedes, the RICO claims arise "from the matrix of" plaintiffs' securities claims. All of the state-law claims which plaintiffs assert against Fryar also arise from the same transactions that underlie plaintiffs' RICO and securities claims against Fryar.

Nonetheless, we cannot simply affirm the district court's award, for that court awarded attorneys' fees against all of the defendants who stood trial. Thus, the court awarded attorneys' fees for all of the legal work necessary to develop and try plaintiffs' case. Plaintiffs developed much of their case, however, to obtain a verdict against WLJ. Several of plaintiffs' legal theories and arguments applied only to WLJ; indeed, at least one of their claims (for legal malpractice) implicates *only* WLJ.

Consequently, the district court must readjust the attorneys' fees award to compensate plaintiffs only for the legal resources which they expended to develop a case against Fryar and All American. For this purpose, we will remand.

D. *Judicial Interest.*

To all of these awards, the district court added twelve percent per annum judicial interest calculated from the date of judicial demand. The defendants claim that they should not have to pay this interest, totaling about $1,000,000, on these awards because they are already paying damages equal to the interest rate which the bonds bear. The plaintiffs counter that the district court properly imposed judicial interest upon the lost interest damages, since the district court awarded lost interest to the plaintiff class to compensate plaintiffs for the loss of the use of money that rightfully belonged to them.

The plaintiffs are correct. We add that the lost interest payments, which would have been due on virtually all the bonds until at least 1998, have already been discounted to present value. These damages do not represent the face value of the interest payments as they would have continued to come due, but the resale value, at a specific point in the past, of the right to receive those payments in the future. Consequently, the damages awarded for lost interest reflect losses which the plaintiffs have already sustained, not losses they will sustain in the future. The district court properly applied judicial interest.

## VII. *Valley Forge's Appeal.*

Valley Forge, WLJ's malpractice insurer, has also appealed this case on a coverage question. The court tried Valley Forge along with All American, Fryar, and WLJ, and after trial adjudged Valley Forge liable *in solido* for all the awards against WLJ. Those awards exposed Valley Forge to potential liability exceeding $9,000,000. Valley Forge argues on appeal that WLJ's policy limits are $5,000,000, not the $10,000,000 the district court found.

We do not reach this argument. We merely note that Valley Forge is liable only to the extent WLJ is. Since we have reversed every basis for imposing liability upon WLJ, we now vacate the district court's judgment to the extent it imposes liability upon Valley Forge, and we dismiss Valley Forge's appeal.

## VIII. *Jury Tampering.*

To summarize what we have held thus far: WLJ and Valley Forge are not liable under any legal theories of this case. Fryar, as a matter of law, is not liable under section 12 of the Securities Act or the LBSL, or to the plaintiff class for violating rule 10b-5 or any other state-law claims based upon misrepresentation. The evidence sufficiently supports Abell's and Walton's individual rule 10b-5 and state-law misrepresentation claims against Fryar, but the damages for those claims must be recalculated, because damages were determined for the entire class and not just Abell and Walton. Sufficient evidence also supports the jury verdict holding Fryar liable to the class for violating RICO, but the damage award must be reduced by one-

third to avoid double recovery. Sufficient evidence, moreover, supports all of the damage awards. Finally, the district court properly awarded attorneys' fees against Fryar and All American but improperly against WLJ and Valley Forge.

We review all these holdings at this stage in the opinion to remind the reader which are issues of law and which ones are based merely upon the sufficiency of the evidence. The importance of that distinction will soon become apparent, as we now turn to allegations that Fryar prejudiced the jury against himself by trying to bribe one of its members.

A. *The Relevant Procedural Facts.*

A little over a month into the trial, the judge received information from the FBI that Fryar was attempting to bribe several members of the jury. The FBI continued to investigate this allegation, but it had probable cause to believe that Fryar had targeted and contacted jurors Terracina and Teer. The judge questioned an FBI agent extensively *in camera*, outside the presence of the defendants and their attorneys, and satisfied itself that probable cause existed to believe that Fryar indeed had attempted to bribe Terracina and Teer.

The judge sealed the record of this *in camera* hearing, and kept the information to himself until the last day of trial. On that day, he called the attorneys into his chambers, informed them that he had probable cause to believe that someone was tampering with jurors Terracina and Teer, and told them that he would excuse those jurors without giving any specific explanations to the

jury. In open court, the judge excused Terracina and Teer from the jury, reducing the size of the jury to the six jurors who would deliberate the case.

After several hours of deliberation, the jury returned its verdict against the defendants. Immediately afterwards, the trial judge examined each of the jurors individually, outside the presence of the other jurors but in the presence of all the attorneys. Each of the jurors claimed to have heard nothing about the bribery attempt, and each swore that nothing had affected his or her decision. After this voir dire, the judge released the jurors to the custody of the FBI and the marshals so that these law enforcement authorities could continue their jury-tampering investigation.

In the course of this police investigation, the FBI determined that most of the jurors actually knew about Fryar's attempt to bribe Terracina. When the court found out that the jurors had lied about their knowledge of Fryar's bribery attempts, it conducted a second voir dire, also in the presence of the attorneys.

In this second voir dire, the court determined that the jurors had decided collectively not to admit their knowledge of the bribery attempts. Each juror testified the second time that he or she had lied the first time because he or she did not consider the bribery stories that Terracina told to be the truth, and each juror wanted to avoid even the possibility of a mistrial, because the jurors did not want their efforts to go for naught.

Terracina was viewed universally by his co-jurors as an unstable, unpredictable individual. Consequently, none of the jurors believed Terracina when he informed

them that Fryar had offered him $10,000 to vote for Fryar. Some of the jurors discussed Terracina's story among themselves, and came to the same conclusion.

None of the jurors, however, had heard anything about any attempts to bribe Teer, a much more respected member of the panel. The jurors testified that they had been disappointed, and somewhat surprised, when the judge excused Terracina and Teer.

Most of the jurors testified that they had assumed that the last two jurors chosen were alternates and would be the ones to be excused at the end of the trial. Since neither Terracina nor Teer was among the last two jurors chosen, several of the jurors immediately began to speculate as to why those jurors had been excused. A few admitted that they began to wonder whether there was any truth to the stories which Terracina had been telling them. Indeed, it was shortly after Terracina and Teer were excused that the jurors discussed what to do if asked about Terracina's story, and it was then that the jurors decided that they would lie.

Nonetheless, each of the jurors continued to insist that he or she still did not believe Terracina's story. Moreover, each juror insisted that what he or she knew about Fryar's attempts to bribe Terracina had nothing to do with his or her own personal decisions in deliberating the case.

The trial judge chose to believe the jurors' testimony that they had not been prejudiced. Additionally, the trial judge noted that he considered the verdict to be an imminently fair and reasonable one that showed no signs of prejudice. Nevertheless, Fryar asks us to grant him a new trial.

B. *The Law.*

The constitution, through the due process clause of the fifth amendment and the right to jury trial enshrined in the sixth and seventh amendments, requires federal courts to give every defendant a fair trial. *Haley v. Blue Ridge Transfer Co.*, 802 F.2d 1532 (4th Cir.1986). It has been written in even the most ancient authorities that the constitution guards against even the appearance that prejudice has infected a jury. *See Budoff v. Holiday Inns, Inc.*, 732 F.2d 1523 (6th Cir.1984) (describing nineteenth-century cases).

Until recently, courts generally agreed that any extra-judicial contact or material reaching the jury presumptively prejudices it. *See Haley; United States v. Butler*, 822 F.2d 1191 (D.C.Cir.1987). Under *Remmer v. United States*, 347 U.S. 227, 74 S.Ct. 450, 98 L.Ed. 654 (1954), the party supporting the jury's verdict carried a heavy burden to disprove jury prejudice.[48] *See Haley; Butler; United States v. Forrest*, 620 F.2d 446 (5th Cir.1980). However, the Supreme Court cast a forboding shadow on these assumptions when it decided *Smith v. Phillips*, 455 U.S. 209, 102 S.Ct. 940, 71 L.Ed.2d 78 (1982).

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48. In a criminal case, any private communication, contact, or tampering directly or indirectly, with a juror during a trial about the matter pending before the jury is, for obvious reasons, deemed presumptively prejudicial, if not made in pursuance of known rules of the court and the instructions and directions of the court made during the trial, with full knowledge of the parties. The presumption is not conclusive, but

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There, the Court reversed the Second Circuit's judgment granting a writ of habeas corpus to a New York inmate convicted of murder. Shortly after the state murder trial began, one of the jurors applied to the prosecutor's office for a job in a newly-formed investigative department. The prosecutor himself did not know about the juror's job application until several days into the trial, and thought it too insignificant to tell the judge when he did find out. When the trial judge was informed, he held a hearing to determine whether the juror's contact with the prosecutor's office had biased the juror against the defendant. After hearing testimony from the prosecutor and Smith, the trial judge found " 'no evidence' suggesting [the juror bore] 'a sinister or dishonest motive' "[49] or had been prejudiced.

The defendant, now convicted, eventually petitioned the district court for a writ of habeas corpus. The court

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> the burden rests heavily upon the Government to establish, after notice to and hearing of the defendant, that such contact with the juror was harmless to the defendant.

347 U.S. at 229, 74 S.Ct. at 451 (citations omitted). We have long held that "the integrity of the jury system is no less to be desired in civil cases." *United States v. Harry Barfield Co.*, 359 F.2d 120, 124 (5th Cir.1966). *See also Haley; Hobson v. Wilson*, 737 F.2d 1 (D.C.Cir.1984), *cert. denied*, 470 U.S. 1084, 105 S.Ct. 1843, 85 L.Ed.2d 142 (1985); *Butler.*

49. 455 U.S. at 214, 102 S.Ct. at 944 (quoting from the trial court's findings in *People v. Phillips*, 87 Misc.2d 613, 618-19, 384 N.Y.S.2d 906, 910 (1975)).

granted the writ. 485 F.Supp. 1365 (S.D.N.Y.), *aff'd*, 632 F.2d 1019 (2d Cir.1980). Both the district court and the court of appeals held that the trial court should have *conclusively* presumed prejudice from the facts. 455 U.S. at 214, 102 S.Ct. at 944.

The Supreme Court reversed, holding that due process requires only that the trial court hold a *Remmer* hearing to determine whether the juror has been prejudiced. Citing *Remmer*, the court wrote,

> This Court has long held that the remedy for allegations of juror partiality is a hearing in which the defendant has the opportunity to prove actual bias.

*Id.* at 215, 102 S.Ct. at 945. Later, the Court added that

> . . . due process does not require a new trial every time a juror has been placed in a potentially compromising situation. Were that the rule, few trials would be constitutionally acceptable. The safeguards of juror impartiality, such as *voir dire* and protective instructions from the trial judge, are not infallible; it is virtually impossible to shield jurors from every contact or influence that might theoretically affect their vote. Due process means a jury capable and willing to decide the case solely on the evidence before it, and a trial judge ever watchful to prevent prejudicial occurrences and to determine the effect of such occurrences when they happen. Such determinations may properly be made at a hearing like that ordered in *Remmer* and held in this case.

*Id.* at 217, 102 S.Ct. at 946 (footnote omitted).

The bondholders argue that *Smith v. Phillips* overruled *Remmer's* heavy presumption of juror prejudice. According to the bondholders, *Smith v. Phillips* requires the party *challenging* the jury verdict to prove prejudice.

Defendants respond that *Smith v. Phillips* is distinguishable, primarily because it was a habeas challenge to a state trial, not a direct appeal.

Several of our sister circuits already have considered this question squarely. In *United States v. Pennell*, 737 F.2d 521 (6th Cir.1984), *cert. denied*, 469 U.S. 1158, 105 S.Ct. 906, 83 L.Ed.2d 921 (1985), the court concluded that the *Remmer* presumption had been overruled. There, five jurors received anonymous, early-morning calls instructing them to convict a criminal defendant. The Sixth Circuit refused to order a new trial because the district judge had held a hearing and determined that the defendant had not proved prejudice.

*Pennell*, however, has not been accepted in any other circuit, and three circuits have explicitly rejected the argument that the challenging party must prove prejudice.[50] Other cases, while not facing the question directly, have continued to apply the *Remmer* presumption despite *Smith v. Phillips*.[51] We have applied the *Remmer* presumption since *Smith v. Phillips;* however, we have not yet explicitly determined how *Smith v. Phillips* has affected *Remmer*. *See United States v. Webster*, 750 F.2d 307, 336-39

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50. *See United States v. Littlefield*, 752 F.2d 1429, 1431-32 (9th Cir.1985) (criticizing *Pennell*); *Haley*, 802 F.2d at 1535 (distinguishing *Phillips*); *Butler*, 822 F.2d at 1195-96 n. 2 (rejecting *Pennell* and concluding that "*Remmer's* allocation of the burden remains the law").

51. *See, e.g., Owen v. Duckworth*, 727 F.2d 643 (7th Cir.1984); *United States v. Delaney*, 732 F.2d 639, 643 (8th Cir.1984); *United States v. Hines*, 696 F.2d 722, 730-31 (10th Cir.1982); *Hobson v. Wilson*, 737 F.2d 1, 47-49 (D.C. Cir.1984), *cert. denied*, 470 U.S. 1084, 105 S.Ct. 1843, 85 L.Ed.2d 142 (1985) (civil case).

(5th Cir.1984), *cert. denied*, 471 U.S. 1106, 105 S.Ct. 2340, 85 L.Ed.2d 856 (1985). *Webster* does not explicitly take account of *Smith v. Phillips*. Moreover, it specifies that where *outside* influence on the jury is alleged, "a presumption of prejudice arises," and it is incumbent upon the government to rebut that presumption at a hearing. 750 F.2d at 338.

We do not find this dictum in *Webster* to be controlling here. It is not evident that the panel was cognizant of the new standard, suggested in *Smith v. Phillips*, that no longer assumes jury prejudice. Further, *Webster* noted that "we do not find it necessary to decide if a presumption of prejudice should be applied in all cases of this nature." *Id.* at 339.

More importantly, and irrespective of the question of who must carry the burden, it is evident here that the trial court properly conducted a hearing, with jurors, that satisfies the requirements of both *Smith v. Phillips* and *Webster*. *Smith v. Phillips* requires a "hearing in which the defendant has the opportunity to prove actual bias." 455 U.S. at 215, 102 S.Ct. at 945. Quoting *Remmer*, 347 U.S. at 230, 74 S.Ct. at 451, the Court noted that at the hearing, the trial judge should " 'determine the circumstances, the impact thereof upon the juror, and whether or not [they were] prejudicial, in a *hearing* with all interested parties permitted to participate.' " 455 U.S. at 216, 102 S.Ct. at 945 (emphasis added in *Smith v. Phillips*). In *Webster*, the panel noted specifically that "[c]ounsel should be present at any hearing held to assess outside influence on the jury." 750 F.2d at 338 (citing *United States v. Forrest*, 620 F.2d 446 (5th Cir.1980)).

In the case which we now review, the district judge amply met these requirements, examining the jurors[52] separately in two special post-verdict hearings at which all counsel were present. After carefully considering all of the facts available to him, and examining the demeanor of the jurors during questioning, he concluded that no prejudice had been established.

It is appropriate here that we respect that determination by the fact-finder. The panel in *Webster* emphasized the extensive deference that should be accorded the trial judge in assessing juror bias. As in *Webster*, we "think the trial court did an admirable job of evaluating the extent of prejudice without contributing to the problem by over emphasis. Moreover, we agree with the trial court that the interviews reveal that the jury was still capable of impartiality." *Id.* at 339. In other words, the trial court had the right to believe the jurors' unanimous testimony that bribery did not affect their verdict.

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52. *Smith v. Phillips* speaks to the propriety of questioning the jurors:

> Respondent correctly notes that determinations made in *Remmer*-type hearings will frequently turn upon testimony of the juror in question, but errs in contending that such evidence is inherently suspect. As we said in *Dennis v. United States*, 339 U.S. 162, 70 S.Ct. 519, 94 L.Ed. 734 (1950), '[o]ne may not know or altogether understand the imponderables which cause one to think what he thinks, but surely one who is trying as an honest man to live up to the sanctity of his oath is well qualified to say whether he has an unbiased mind in a certain matter.' *Id.*, at 171, 70 S.Ct., at 523. See also *United States v. Reid*, 12 How. 361, 366, 13 L.Ed. 1023 (1852).

455 U.S. at 217 n. 7, 102 S.Ct. at 946 n. 7.

Even if we were not convinced that the district court correctly found an absence of jury prejudice here, we would not permit the perpetrator of jury tampering, in a civil proceeding, to reap the rewards of his misdeed by enjoying a new trial.[53] "Our system of justice has not delegated to every reprobate the power to effect a mistrial." *United States v. Williams*, 737 F.2d 594, 612 (7th Cir.1984), *cert. denied*, 470 U.S. 1003, 105 S.Ct. 1354, 84 L.Ed.2d 377 (1985). *See also Butler*, 822 F.2d at 1196–n. 2 (quoting *Williams*).

We are mindful that in *Forrest*, a criminal case, we held that the defendant should receive a new trial even though he had tampered with the jury that convicted him. *See* 620 F.2d at 458-59. However, in *Forrest* we did not specifically extend the holding to civil proceedings and see no reason to do so now. The liberty interests inherent in a criminal proceeding provide justification for a different result there.

Moreover, equity plays such a central role in our civil jurisprudence that we are loathe to permit civil litigants to view jury tampering as a "heads I win, tails you lose" proposition whereby a party who tampers with the jury might win if he is not caught, and receive a new trial if he is. Accordingly, we hold that Fryar is not entitled to a new trial.

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53. We note that Fryar has been convicted of using Terracina's uncle to offer Terracina a $10,000 bribe. *United States v. Fryar*, No. CR-87-60027-01 (W.D. La., conviction entered Mar. 14, 1988), *appeal docketed*, No. 88-4200 (5th Cir. Mar. 14, 1988).

## IX. *Conclusion.*

We REVERSE the judgment against WLJ and Valley Forge. We also DISMISS Valley Forge's appeal as moot to the extent that the appeal challenges the judgment concerning the coverage limits of WLJ's policy.

We REVERSE the district court's judgment against Fryar to the extent it is based upon section 12 of the Securities Act or the LBSL. We also REVERSE the court's judgment awarding damages to the class against Fryar for violating rule 10b-5, and for violating Louisiana law. We AFFIRM the district court's judgment concerning liability upon the RICO claims against Fryar, and Abell's and Walton's rule 10b-5 claims and non-securities state-law claims against Fryar. Consequently, we also REVERSE and REMAND the attorneys' fees award against Fryar for redetermination in light of our holdings regarding the liability and non-liability of the various defendants.

We REVERSE and REMAND the damage awards, for redetermination in accordance with the discussion of damages in this opinion. In addition to the ultimate damage award, the court may also award any appropriate judicial interest.

The judgment is AFFIRMED IN PART, REVERSED IN PART, and REMANDED.

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF LOUISIANA
LAFAYETTE-OPELOUSAS DIVISION

EDWARD C. ABELL, JR., ET AL

VS.

POTOMAC INSURANCE COMPANY OF ILLINOIS

CIVIL ACTION NUMBER 84-1786

SECTION 0

*R U L I N G*

(Filed March 26, 1987)

Now before the court are the motions for judgment notwithstanding the verdict and motions for a new trial, filed on behalf of defendants Joe E. Fryar ("Fryar"), All American Services Co., Ltd. ("All American"), Wright, Lindsey & Jennings ("WLJ") and Valley Forge Insurance Company.

On February 4, 1987, after nine weeks of trial, the court excused two jurors, prior to the commencement of jury deliberations, and replaced the jurors with two alternate jurors. In an effort not to prejudice nor to intimidate the jury, the court merely informed the jury that only six jurors were needed to deliberate, and, therefore, that two jurors must be excused. After the replacement, the court informed the attorneys for the parties that the court had replaced two of the jurors with the two alternate jurors because the court had reason to believe that the two excused jurors should have been excused. The court then issued reasons for this ruling, which reasons were filed under seal. That same day, the jury returned a verdict for plaintiffs against all defendants; furthermore, the jury

allocated a percentage of liability to all defendants, including those defendants who had settled prior to trial. The jury found that all defendants had violated Sections 12(1) and 12(2) of the Securities Act of 1933, Sections 10b-5(1) and (3) and 10b-5(2) of the Securities & Exchange Act of 1934, the Louisiana Blue Sky Law, and other state laws. The jury further found that defendants Fryar and All American had violated Sections 1962(a), (b) and (c) of the Racketeer Influenced and Corrupt Organizations ("RICO") Act. The jury awarded damages in excess of $15.8 million.

Defendants have moved for a judgment n.o.v., contending that the proof on certain issues was not sufficient to permit any reasonable juror to find liability. Plaintiffs assert that the judgment entered upon the jury findings is abundantly supported by substantial evidence. In considering a motion for judgment n.o.v., this court may not weigh the evidence; rather, it must determine whether, after considering all the evidence in the light most favorable to the non-moving party, the jury reasonably could have found for the non-moving party. *See Bazile v. Bisso Marine Co., Inc.*, 606 F.2d 101 (5th Cir. 1979), *cert. denied*, 449 U.S. 829, 101 S. Ct. 94 (1980); *Boeing Company v. Shipman*, 411 F.2d 365 (5th Cir. 1969).

Defendants further petition this court for a new trial on the grounds that the jury was not impartial. It is the obligation of this court to set aside the verdict and to grant a new trial only if the court is convinced that the verdict is not supported by the clear weight of the evidence. Thus, the court must accept the jury's verdict if it is one which could reasonably have been reached. *TCP*

*Industries, Inc. v. Uniroyal, Inc.*, 661 F.2d 542, 546 (6th Cir. 1981).

I. Motions for Judgment Notwithstanding the Verdict.

A. 10b-5 Claims.

Defendants first contend that the existence of the prior feasibility study, rendered by the nationally recognized firm of Booz, Allen & Hamilton, Inc. ("Booz, Allen") is not a material fact which the defendants were required to disclose. This assertion is clearly unsupportable. A fact is material if a reasonable person would have attached importance to the fact in determining his course of action. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 543 (5th Cir. 1981). Generally, the jury is responsible for determining whether or not a fact is "material", within the meaning of the securities laws.

The evidence at trial clearly establishes that the Booz, Allen report was a material fact which required disclosure. Plaintiffs Edward Abell and Carey Walton both testified unequivocally that the disclosure of the Booz, Allen report would have changed their investment decision. Furthermore, James Perkins, former president of the National Association of Bond Lawyers, testified that the existence of the prior feasibility study was a material fact which should have been disclosed. *See Securities & Exchange Com'n v. Senex Corporation*, 399 F. Supp. 497 (E.D. Ky. 1975).

Defendants further categorize as immaterial the fact that the purchase price Westside Habilitation Center ("Westside") paid for the Cheneyville property was

highly inflated, thus providing a source of funds to purchase $2 million of bonds, to be pledged to secure Fryar's performance. The uncontested testimony of Perkins, David Menz, a partner of WLJ, and Robert Sheddy, who was also involved in the transaction, established that any fact bearing upon the risk of reimbursement and the ability to generate revenues is material. The evidence further established that Westside's sole source of revenue was the Medicaid program, and that the inflation of the purchase price could lead to disallowance of certain reimbursement claims by the Louisiana Department of Health and Human Resources ("DHHR"). This disallowance would result in a short-fall of at least $300,000 annually. Furthermore, Perkins testified that the inflation of the purchase price was material because it subtantially increased the cost of care and it may have caused consternation within the referring agencies. Maxine Hanks, director of DHHR Rate Administration, and Charles Fine, an integral player in Fryar's transaction, testified that disclosure of the details of the property transaction adversely affected referrals.

Defendants further aver that no reasonable juror could have found that defendants' violations of Rule 10b-5 caused plaintiffs' losses. Rather, defendants submit that the bankruptcy proceeding and the change in DHHR's method of reimbursement were the sole causes of plaintiffs' injuries. To establish causation in a Rule 10b-5 claim, plaintiffs need only show that the omissions and misrepresentations "touched upon" the reasons for the investment's decline in value. Plaintiffs need not establish that the misrepresentations or omissions were the sole, exclusive, or primary cause of the plaintiffs'

losses. *Chemetron Corp. v. Business Funds, Inc.*, 682 F.2d 1149, 1162 (5th Cir. 1982), *cert. denied*, 460 U.S. 1013, 103 S. Ct. 1254 (1983). Plaintiffs clearly established the requisite causation between defendants' violations and plaintiffs' injuries. Charles Fine, Fryar's witness, conceded on cross-examination that disclosure of the true details of the property transaction resulted in DHHR imposing a freeze on referrals, which freeze resulted in Westside's inability to generate sufficient revenues to pay its debts. Mr. Baxley, also Fryar's witness, corroborated this testimony. Furthermore, defendants' claim that the failure of the Penn Square Bank caused delays and loss of money to the project that resulted in the Westside bankruptcy proceedings is unfounded. The facility was completed on schedule, and Westside lost at most only $300,000 as a result of the Penn Square Bank failure, a sum less than the interest paid to All American on the $2 million in bonds it received, for which it paid nothing.

WLJ argues that there was no evidence from which a jury could conclude that it acted with the requisite scienter to have violated Rule 10b-5. WLJ's claim, however, ignores the well-established trend that a defendant who acts with severe recklessness satisfies the scienter requirement. *Broad v. Rockwell Intern. Corp.*, 642 F.2d 929, 961 (5th Cir. 1981), *cert. denied*, 454 U.S. 965, 102 S. Ct. 506 (1981); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 544 (5th Cir. 1981). Plaintiffs have established that WLJ acted with severe recklessness by proving that WLJ showed "an extreme departure from the standards of ordinary care." *Broad v. Rockwell Intern. Corp.*, 642 F.2d at 961-62. Perkins testified that underwriters' counsel, such as WLJ, has the obligation to perform a due diligence investigation,

wherein counsel would ensure that the offering documents adequately disclose all material facts. Moreover, Perkins testified that it is the responsibility of underwriters' counsel to question all participants in the transaction, including the developer and the feasibility consultant, in order to ensure that all material facts have been disclosed. More importantly, Perkins testified that underwriters' counsel cannot rely upon information provided by his or her client, the underwriters, because the underwriters may conceal facts which, if disclosed, might hinder the sale of the bonds. It is clear that the withdrawal of other law firms, such as the illustrious New York firm of Mudge, Rose, and the failure of the transaction to be approved by the State Bond Commission, required heightened due diligence on the part of WLJ. Moreover, it is spurious for WLJ to claim as a defense to its negligence the fact that it began to represent the underwriters late in the proceedings.

WLJ's performance clearly constituted severe recklessness and a departure from the standards of ordinary care. WLJ did not personally question anyone about the transaction, other than the underwriter, Hancock, who was aware the transaction was the subject of an investigation by the Securities & Exchange Commission, the National Association of Securities Dealers, and the Federal Bureau of Investigation. Neither Menz nor anyone from WLJ questioned Fryar, the feasibility consultant, Westside's board of directors, the management company, Westside's accountant, the director of Rate Administration, or All American. Moreover, Menz did not even review the Booz, Allen report. Nevertheless, Menz prepared, reviewed, and revised offering documents, such as

the Summary Memorandum and the Preliminary Official Statement.

Defendants further contend that because plaintiffs Abell and Walton did not themselves read the Official Statement prior to their purchase of the bonds, the requisite element of reliance in a Rule 10(b)-5 claim was not established, and that, therefore, the plaintiffs cannot recover under either Section 10(b) or Rule 10b-5. This assertion is specious and is unfounded in the law. The law is clear that, to establish a claim under Rule 10b-5(2), alleging primarily a failure to disclose, the plaintiffs need only prove that an omission of material fact, made with scienter, contributed to their injury. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 92 S. Ct. 1456 (1972), *reh. denied*, 407 U.S. 916, 92 S. Ct. 2430 (1972) and *reh. denied*, 408 U.S. 931, 92 S. Ct. 2478 (1972); *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102, 103 S. Ct. 722 (1983); *Huddleston v. Herman & MacLean*, 640 F.2d at 543; *Croy v. Campbell*, 624 F.2d 709, 715 (5th Cir. 1980); *Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187, 193-94 (5th Cir. 1979), *aff'd in part, vacated and remanded on rehearing*, 611 F.2d 105 (5th Cir. 1980); *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir. 1977), *cert. denied*, 434 U.S. 911, 98 S. Ct. 312 (1977). Moreover, in an omission action, such as this case, reliance is presumed, upon a showing that the withheld facts were material. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. at 153-54, 92 S. Ct. 1472. Moreover, even though plaintiffs did not actually read the Official Statement, they read and they relied upon a written sales circular describing the offering which omitted material facts. Walton himself testified that it was specifically represented to him that

the project was feasible and that the developer had $2 million of his own at risk. Moreover, plaintiffs clearly proved secondary reliance on the sales circular and oral representations by defendants. Notwithstanding that each investor may not have read the Official Statement, the brokers who advised these investors did read and did rely upon the Official Statement. Mr. Sheddy and Robert Crayne, a former Swink broker, corroborated this conclusion. *See Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730 (W.D. Va. 1982).

Defendants argue that plaintiffs cannot recover on a fraud on the market theory because they failed to establish that the bonds were worthless and that the bonds were traded on a public market. This assertion is entirely without merit. Contrary to defendants' contention, to prove a party violated Rule 10b-5(1) and (3), plaintiff need only show that the party: (1) employed a device, scheme, or artifice to defraud, or engaged in a course of business that operates as a fraud; (2) with scienter; (3) upon which the plaintiff relied; and (4) that caused an injury. *Shores v. Sklar*, 647 F.2d at 469; *Kennedy v. Tallant*, 710 F.2d 711 (11th Cir. 1983). Thus, defendants' assertion of a worthless requirement in a Rule 10b-5 claim is unfounded.

B. Section 12 Claims and Louisiana Blue Sky Law.

Defendants contend that the bonds were exempt from registration with the Securities & Exchange Commission and the Louisiana Securities Commission because Westside, the issuer, is a non-profit organization. This assertion is obviously specious. The mere non-profit

status of an entity does not assure entitlement to the exemption. Rather, the exemption will be held inapplicable where a substantial purpose of the organization of the entity is to enrich the promoters by providing them with large profits for the enterprise. *Securities and Exchange Com'n v. Children's Hospital*, 214 F. Supp. 883, 888-89 (D. Ariz. 1963). The jury could reasonably conclude from the evidence presented at trial that a substantial purpose of the organization of Westside was to enrich Fryar and All American by providing them with large profits. Fryar himself testified that he had pecuniary motives in becoming involved in the transaction. Furthermore, All American received in excess of $700,000 in interest payments, for which it had performed absolutely no services. The evidence presented by defendants to prove All American's obligations on behalf of Joe Fryar, in consideration for receiving $2,459,000 for a piece of property that cost it only $150,000, was a letter from All American which mysteriously appeared during the course of the trial. The letter was dated November, 1981, wherein All American agreed to buy the property which it had already purchased in August, 1981. Moreover, defendants relied upon a copy of a resolution of All American, delineating All American's obligations. Defendants could not find the original of the resolution, and, strangely enough, the document was not produced at plaintiffs' request during discovery. This resolution is quite puzzling in view of the fact that Chambers, who was President of All American, testified by deposition prior to his death that the only obligation that All American owed to Fryar was to pledge the $2 million in bonds to Westside's trustee, to secure Fryar's obligation.

WLJ also argues that the exemption from registration for "transactions by any person other than an issuer, underwriter, or dealer" is applicable. 15 U.S.C. § 77d(l). This argument is belied by case law. The exemption is not available to any participant in a transaction in which the issuer, underwriter, or dealer is offering or selling securities. *Securities & Exch. Com'n v. Murphy*, 626 F.2d 633 (9th Cir. 1980); *Securities & Exchange Commission v. Chinese Consol. Benev. Ass'n Inc.*, 120 F.2d 738, 741 (2d Cir. 1941). WLJ clearly was a participant in such a transaction.

WLJ further argues for the first time that attorneys are exempt from the Louisiana Blue Sky Law. Because WLJ neither asserted this argument in its pleadings nor in the pre-trial order, WLJ cannot raise the issue for the first time after trial via post-trial motions. *See Flannery v. Carroll*, 676 F.2d 126 (5th Cir. 1982); *Adams v. Thompson*, 560 F. Supp. 894 (M.D. La. 1983). Be this as it may, WLJ's contention is unsupportable. The Louisiana Blue Sky Law is analogous to the Securities Act of 1933. Federal courts have construed the term "seller", within the meaning of the Securities Act of 1933, to include those parties who are a substantial factor in causing the transaction to occur. This analysis provides guidance to courts which are construing the Louisiana Blue Sky Law. See *Ek v. Nationwide Candy Division, Ltd.*, 403 So.2d 780, 785 (La.App. 3rd Cir. 1981).

Defendants aver that they cannot be held liable for violations of Section 12 because they were not sellers of the bonds. This argument defies logic. The law is clear that "seller", within the meaning of Section 12(2), is not required to be in strict privity with the purchasers.

Rather, a party may qualify as a "seller" if it is a "substantial factor" in causing the transaction to occur. *Junker v. Crory*, 650 F.2d 1349 (5th Cir. 1981); *Pharo v. Smith*, 621 F.2d 656 (5th Cir. 1980). Thus, courts have held promoters of a venture and attorneys to be liable as sellers, within the meaning of Section 12(2). *See Hill York Corporation v. American International Franchises, Inc.*, 448 F.2d 680, 693 (5th Cir. 1971); *Excalibur Oil Inc. v. Sullivan*, 616 F. Supp. 458 (N.D. Ill. 1985).

The evidence presented at trial clearly establishes that all of the defendants were sellers, within the meaning of Section 12(2). Fryar was the mastermind behind the Westside transaction. Sheddy testified that Fryar not only fomented the project, Fryar was the organizer and the financier of the project. Sheddy further testified that, but for Fryar's involvement, the bonds would have not been issued. Menz corroborated this testimony by commenting that he believed that Fryar's role in the project was substantial. Mr. Kendrick testified that Fryar, rather than the Board of Directors, made the decisions for the project.

Further evidence was produced at trial which clearly supported the jury's finding that WLJ and All American were "sellers", within the meaning of Section 12(2). Sheddy testified that, but for the role WLJ as underwriters' counsel played, the bonds would not have been issued. Sheddy further testified that the underwriters relied upon WLJ to ensure that adequate disclosure had been made in offering the documents, which documents had been prepared and/or reviewed by WLJ. Perkins testified that, in a bond offering, underwriters' counsel plays a substantial role. Perkins corroborated Sheddy's

testimony that, but for the role WLJ played in the transaction, the bonds would not have been issued.

All American's role in the transaction clearly constituted that of a "seller", within the meaning of Section 12(2). Fryar himself testified that, but for All American's role, he would not have proceeded with the transaction. Indeed, All American's role was integral to the transaction, despite the clearly established fact that All American's only obligation in the entire transaction was to pledge the $2 million in bonds to secure Fryar's obligation. Had All American not pledged these bonds, Fryar's machinations would not have transpired.

Defendants assert that plaintiffs have somehow abandoned their Section 12 claims and that, therefore, the remedy of recission is not available to them. This assertion is incorrect. Plaintiffs' pre-trial order, plaintiffs' proposed jury instructions, and the court's jury instructions all reflect plaintiffs' entitlement to the remedy of recission. Indeed, recission is the only remedy afforded a litigant under Section 12. 15 U.S.C. § 771. Moreover, once a defendant is held to be liable as a seller under Section 12, he is subject to the recission remedy, even though he may not be the direct seller. *Hill York Corporation v. American International Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971).

C. Louisiana Blue Sky Law.

Fryar contends that plaintiffs cannot recover under the Louisiana Blue Sky Law because they failed to prove knowledge of a misrepresentation and reliance on the misrepresentation. Fryar's assertion is completely

unfounded. Under the Louisiana Blue Sky Law, as under Section 12(1) of the Securities Act of 1933, reliance is not an element of a claim for failure to register the security with the Louisiana Securities Commission. Moreover, proof of reliance is not a prerequisite for a violation of LSA-R.S. 51:712A(2). *See Caldwell v. Trans-Gulf Petroleum Corp.*, 322 So.2d 171 (La. 1975); *Securities & Exchange Com'n v. Southwest Coal & Energy Company*, 624 F.2d 1312 (5th Cir. 1980); *Larson v. Tony's Investment, Inc.*, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. [CCH] ¶92,324 at 97,532 (M.D. Ala. 1968) (that plaintiff did not see a prospectus before purchasing shares is not fatal to a Section 12(2) claim).

D. Burden of Proof Under Louisiana Law.

Fryar contends that La. Civ. Code art. 1957 is inapplicable to the present case. That article states:

> Fraud need only be proved by a preponderance of the evidence and may be established by circumstantial evidence.

LSA-C.C. art. 1957.

Fryar's disavowance of article 1957 is devoid of merit, and he offers no authority to support this proposition. Contrary to Fryar's assertion, article 1957 does not change the law. Rather, it restates a principle expressed more than one hundred years ago, in LSA-C.C. art. 1848 (1870).

E. RICO Claims.

Fryar argues that plaintiffs' RICO claims are unsupportable because the plaintiffs have failed to prove a scheme or an artifice to defraud on the part of defendants. In order to establish a scheme or an artifice to defraud, within the meaning of the wire fraud statutes, plaintiffs need only prove the existence of any plan intended to deceive others, and to obtain money or property from persons so deceived, by false or fraudulent pretenses, representations or promises.

Substantial evidence was adduced at trial from which a reasonable jury could infer the existence of a scheme or artifice to defraud. It is obvious that Fryar caused All American to be organized for the express purpose of concealing that a profit in excess of $2 million was to be made on the sale of the Cheneyville property. Fryar was the only party in contact with All American, and it was Fryar who caused the documents necessary to effectuate the scheme to be mailed to All American and to other parties involved in the transaction.

The evidence at trial abundantly supported the jury's finding that Fryar violated Section 1962(a) of the RICO Act. It is clear that Fryar and All American derived in excess of $2 million from the pattern of racketeering activity which resulted from the issuance of the Westside bonds. It is also well established that at least $2.4 million of the racketeering monies was used by Fryar and All American to acquire an interest in Westside by the purchase of Westside bonds, and that at least part of the proceeds of that investment, the interest payments, were paid to Fryar, who was operating Westside.

The evidence adduced at trial also supports the reasonableness of the jury's finding that Fryar and All American violated Section 1962(b) of the RICO Act. Fryar and All American used the racketeering monies to acquire over $2 million of Westside bonds. As a result of the scheme, Fryar controlled and operated Westside, during which time he received all revenues paid by the state of Louisiana to Westside, including revenues paid as reimbursement for the interest owed by Westside to plaintiffs. Nevertheless, Fryar refused to pay this interest to plaintiffs. Moreover, the fact that Westside failed to make demand upon Fryar for return of the revenues further indicates that Fryar controlled Westside.

The evidence also abundantly supports the jury's finding that Fryar and All American violated Section 1962(c) of the RICO Act. The evidence discussed above clearly indicates that Fryar and All American participated in the scheme to issue and to market the Westside bonds, within the meaning of Section 1962(c).

F. Conspiracy or Scheme to Defraud.

Fryar avers that plaintiffs have failed to establish the existence of a conspiracy or a scheme to defraud. This contention is entirely devoid of merit. The evidence adduced at trial clearly established that Fryar fomented and directed the Westside project, and that Fryar, not the board of directors, actually made all important decisions for Westside. But for Fryar's integral involvement, the bonds would not have been marketed. Fryar caused the organization and the incorporation of Westside, the vehicle for accomplishing the scheme. At the time of its

incorporation in 1979, Westside had no capital assets. Rather, its only source of revenue and assets were to be derived through the bond issuance and revenues paid thereafter by the State of Louisiana Medicaid program.

Fryar protected, as it were, his fraudulent scheme by threatening the nationally astute Booz, Allen firm with suit, because of Booz, Allen's adverse conclusions with respect to the feasibility of the Westside project. Fryar then retained Real Estate Research Corporation ("RERC"), a firm with little, if any, familiarity with or knowledge of Louisiana regulations governing reimbursement under the Medicaid programs. Fryar remained undaunted by the subsequent refusal of the Louisiana State Bond Commission to grant approval for the bond issuance, which refusal was generated by questions regarding the principals involved, the amount of profit anticipated to inure to the principals, and opposition to the project by officials of the Louisiana Department of Health and Human Resources. Fryar purchased the Cheneyville property for $100,000. To conceal the fraud, Fryar sold the property for $150,000 in late 1981 to All American, a Bermuda corporation organized to assist Fryar in the transaction. The funds for All American's purchase were obtained from Fryar's underwriting account in a related Bermuda company.

Fryar fomented more fraud to assure the success of his scheme. To secure performance of his obligations as developer under the Development Agreement, Fryar agreed to purchase and to pledge bonds in an aggregate principal amount of $2 million. Fryar thus appeared to have $2 million of his *own* funds at risk, as security for the performance of his obligations, an appearance he

expressly included in the Summary Memoranda, the "Red Herring", and other sales circulars which were distributed to potential investors.

Fryar then grossly inflated the price to be paid by Westside so that over $2 million would be realized from the bond proceeds, which profit would be used to purchase the $2 million of bonds Fryar was required to pledge as security. Structuring the transaction in this manner relieved Fryar of the obligation to put his own funds at risk to secure his performance. It also enabled Fryar and All American to receive a substantial additional profit in the form of the bonds. Fryar's and All American's assertions that the payment to All American of $2,459,000 was payment for All American's assumption of Fryar's obligations pursuant to the Development Agreement is completely belied by the evidence adduced at trial. As was indicated above, these pseudo-obligations on the part of All American were set forth in a copy of a resolution, with no available original, which resolution was not produced during discovery and which mysteriously appeared during the course of the trial.

Fryar's sale of the bonds was permeated with fraud. The Official Statement, sales circulars, and oral representations made to offerees and investors omitted material facts, including, among other things, the omission that Fryar purchased the Cheneyville property for $2 million less than Westside paid for the same property. Moreover, Fryar omitted to disclose the material facts that a feasibility study conducted by the nationally recognized firm of Booz, Allen rendered adverse results, and that Westside most likely was unable to service its debt or to make interest payments to bond purchasers.

G. Aiding and Abetting.

Fryar contends that proof of a conspiracy is necessary to establish liability as an aider or abettor under the federal securities laws. This contention is completely unsupported by the law. The law is clear that to establish that a defendant aided or abetted a violation of the federal securities laws, plaintiffs need only prove: (1) the existence of a federal securities law violation; (2) that the aider or abettor had knowledge of the act; and (3) that the aider or abettor knowingly and substantially participated in the wrongdoing. *See Woodward v. Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975).

H. Statute of Limitations Defense.

Pursuant to an agreement of all the parties, the issue of WLJ's and All American's statute of limitations defense has been decided by the court in a written ruling. The court adamantly maintains its reasoning in this ruling, and, therefore, the court will not readdress this issue.

I. Damages.

Defendants argue that the court erroneously applied the benefit of the bargain measure of damages to the case. Contrary to defendants' assertions, the court never indicated that the only proper measure of damages for state securities violations is the out-of-pocket measure. Rather, the court merely indicated that the out-of-pocket measure of damages is appropriate for federal securities violations. *Huddleston v. Herman & MacLean*, 640 F.2d at 534. However, under Section 12 and under the Louisiana Blue

Sky Law, the remedy of recission is mandatory. That is, Section 12(2) explicitly disallows the plaintiff a choice of remedy. If the plaintiff owns the stock, he is entitled to recission, and not to damages. In contrast, if plaintiff no longer owns the stock, he is entitled to damages, and not to recission. *Wigand v. Flo-Tek Inc.*, 609 F.2d 1028, 1035 (2d Cir. 1979). A plaintiff who no longer owns the security is entitled to damages which would put the plaintiff in the same position as the position in which a plaintiff who still owns the security would be; that is, the plaintiff who no longer owns the security is entitled to recover the amount paid for his or her securities, plus interest thereon from the date of payment to the date of repayment, at the same rates as were originally provided for in the bonds. *Randall v. Loftsgaarden*, ___ U.S. ___, 106 S. Ct. 3143, 3149 (1986).

Defendants also argue that plaintiffs failed to establish the amount of damages. This contention lacks merit. The uncontroverted testimony of plaintiffs' experts, Messrs. Gordon and Derbes, established the amount of damages to which plaintiffs were entitled. Defendants offered no evidence to refute this testimony.

Defendants further contend that plaintiffs failed to produce evidence with respect to damages as to each and every class member. This contention is belied by the fact that the calculations by plaintiffs' expert Derbes were based upon the actual number of bonds, varying interest rates, and amounts paid to date. Plaintiffs also introduced into evidence questionnaires prepared by members of the class, which questionnaires established the date of the purchase. Derbes' testimony was based upon his review of the questionnaires. Gordon testified that the

actual value of the bonds was $1,850 less than par, regardless of the plaintiffs' date of purchase.

Fryar further argues that plaintiffs are not entitled to a damage award of $1,540,000 for breach of fiduciary duty and for violations of article 2315 of the Louisiana Civil Code, because some of plaintiffs still own the bonds. This contention is untenable, and Fryar does not buttress the contention with any compelling authority.

Defendant WLJ argues for the first time that plaintiffs are not entitled to recover because they failed to tender their bonds. This contention is spurious. The law is clear that tender of a security is required only where the recission remedy is applied. *See Wigand v. Flo-Tek, Inc.*, 609 F.2d at 1035. Because the court did not apply the recission remedy, tender is not required. Notwithstanding this fact, actual physical tender is not required. Rather, plaintiffs may tender their bonds in the complaint. *Wigland v. Flo-Tek, Inc.*, 609 F.2d at 1034. Plaintiffs in this case expressly tendered their bonds in paragraph 39 of the complaint.

WLJ further asserts that plaintiffs who are unable to tender cannot recover. This contention directly contradicts the well-established axiom that plaintiffs who no longer own the bonds are entitled to be placed in the same position as those plaintiffs who have tendered their bonds. *See Randall v. Loftsgaarden*, ___ U.S. ___, 106 S. Ct. at 1343.

WLJ also suggests that any damage award to plaintiffs must be reduced by the value of the security held by the plaintiffs. This assertion directly contradicts the benefit of the bargain damage theory. *See Harris v. Union*

*Electric Company*, 787 F.2d 355, 371 (8th Cir. 1986); *Levine v. Futransky*, 636 F. Supp. 899 (N.D. Ill. 1986).

II. Motions for a New Trial.

On February 4, 1987, prior to deliberation of the case by the jury, the court informed counsel in chambers that probable cause to excuse two jurors existed. Because one of the discharged jurors may have been contacted by an outside source and may have revealed the information to one or more of the jurors who deliberated, the court decided that the jurors should be questioned, but only after the verdict was returned, to determine if any contact had been made and, if so, if the contact had been prejudicial to any party. *See Remmer v. United States*, 347 U.S. 227 (1955); *United States v. Forrest*, 620 F.2d 446, 458 (5th Cir. 1980); *Port Terminal & Warehousing v. John S. James Co.*, 92 F.R.D. 100, 105 (S.D. Ga. 1981).

The jurors were questioned in the presence of counsel, and all denied that, prior to their deliberations, they discussed with any other juror, or overheard any other juror discuss, whether anyone had influenced or had attempted to influence any juror's opinion as to the liability or non-liability of any defendant. The court then discharged the jury in the care of the U. S. Marshal for further questioning by the U. S. Attorney.

After questioning the jurors, including the two jurors who did not deliberate, the U. S. Attorney informed the court that five of the six jurors who deliberated had admitted that they either had been told by discharged juror Kent Terracina or had seen a note passed by him to another juror that he had been offered $10,000 by Fryar to

vote in favor of Fryar. The court then requestioned the jurors in the presence of counsel. Their testimony has been sealed, but nevertheless has been made available to all counsel.

The jurors gave the following explanation for not admitting to the court their knowledge of the outside contact. Five of the six jurors advised the court that Juror Terracina was sort of "weird" and "off the wall." They did not believe his story and thought that it was a joke. In fact, some of the jurors continue to disbelieve it. In short, the jurors did not feel that these facts were important enough to be brought to the court's attention and they did not want to make any accusations against anyone based on this type of information. Some jurors were also concerned about a mistrial, after having invested two months of their time in this case. Thus, the jurors agreed among themselves not to relate this information to the court.

The court then questioned the jurors to determine if any prejudice had resulted to the defendant Joe Fryar or any other party as a result of the information revealed by Juror Terracina. Every juror replied that no prejudice had occurred and that the verdict would have been the same "to the penny" had they not been informed about the outside influence. The court believes in the veracity of the jurors, and is firmly convinced that no prejudice occurred.

If there was an attempt to tamper with the jury in this case, it was for the benefit of Joe Fryar alone. There is not a scintilla of evidence to suggest that any other defendant could have been prejudiced. As to Joe Fryar,

the court is of the opinion that there was no prejudice to him. First, some of the jurors did not believe that an attempt was made to tamper because they did not believe Terracina. Second, the court had an opportunity to personally question the jurors, and the court is convinced that no prejudice as to any party tainted the jury's deliberations. Third, the court is of the firm opinion that the verdict is, without dispute, completely supported by the evidence. Defenses advanced by the defendants in this case that may have appeared to have had some relevance at the beginning of the trial have completely vanished. Fryar structured the transactions merely to conceal the fraud. For instance, the defendants' claim that the failure of the Penn Square Bank caused delays and loss of money to the project that resulted in the Westside bankruptcy proceedings is unfounded. The facility was completed on schedule and Westside lost at most $300,000 as a result of the Penn Square Bank failure, a sum less than the interest paid to All American Services Co., Ltd. on the $2 million in bonds it received, for which it paid nothing. The in-use valuation on the facility, advanced by defendants, is totally irrelevant, in light of the fact that the state of Louisiana makes reimbursements, the sole source of revenues for Westside, on appraisals based only on market value.

Moreover, as the court discussed above, evidence presented by defendants to prove All American's obligations on behalf of Joe Fryar in consideration for All American's receipt of $2,459,000 for a piece of property that cost it $150,000, was a letter from All American Services Co., Ltd., which letter mysteriously appeared,

dated November, 1981, agreeing in part to buy the property *which it had already purchased in August of 1981.* Another document relied upon by defendant Fryar was a copy of a resolution of All American Services Co., Ltd. setting forth All American's obligations. No original of this document could be found and the document was not produced when plaintiffs' first demanded it during discovery. This document is very strange in view of the fact that Mr. Chambers, who was President of All American, testified by deposition prior to his death that the only obligation that All American owed to Joe Fryar was to pledge the $2 million in bonds to the trustee for Westside to secure Fryar's obligation.

It is also clear that no prejudice tainted the amount of damages awarded by the jury. To indulge in a little speculation and conjecture, the court will address the question of whether or not any of the jurors who deliberated were approached by Fryar, had failed to reveal the contact to the court, had overreacted in favor of the plaintiffs, and had returned an award of damages in excess of what would have been awarded had there been no contact. The evidence clearly shows that if any prejudice of this sort developed during the trial, it completely dissipated by deliberation day.

The jury awarded $9,594,000 in special interrogatory number 13, the "benefit of the bargain" damage interrogatory. This award is clearly supported by the evidence and is far less than the jury could have awarded, considering that the plaintiff bondholders lost $3,402,146 in past interest payments and also lost $8,638,000, the present value of the money that plaintiffs will lose in the future, due to the reduction of interest payments from 16.5% to

10.45%, for the remaining life of the bonds. These losses are reasonably certain to occur, since no monies have been placed in the missed-interest fund as of the date of the conclusion of the trial. The defendants have not provided the court with any authority that would compel, or even permit, the court to exercise its discretion and to refuse to enter a judgment for the amount awarded in special interrogatory number 13.

Furthermore, the jury's award of damages did not award plaintiffs double recovery. The award against all defendants rendered in special interrogatory number 14, for $2.2 million to compensate the plaintiffs for negligent or intentional misrepresentations or omissions and/or for breach of fiduciary duty, is encompassed in the award made in special interrogatory number 13. The malpractice award against Wright, Lindsey & Jennings and its insurer, Valley Forge Insurance Company, in special interrogatory number 21 in the amount of $300,000 is also encompassed within the award entered in special interrogatory number 13. In constructing the interrogatories, the court and the parties were aware that overlapping awards could be made and that the court would formulate a judgment to avoid double recoveries. Further, the jury was also instructed along these lines. At page 89 of the jury charge the court instructed the jury as follows:

> As you can see from the interrogatories that I have given you, several questions have been asked concerning damages under different statutes and different theories of recovery. First, you should not draw any inference from the fact that a damage interrogatory has been asked. Secondly, you are to answer each interrogatory separately and award damages, if appropriate, independent of damages which you may

award under another interrogatory. Upon your completion of the interrogatories, the court will then decide which awards, if made, will actually be awarded to the plaintiffs.

A review of the record with regard to liability and damages convinces the court that the damages represent a fair verdict which is abundantly supported by the evidence and is untainted by prejudice or favor to any party.

IV. Conclusion.

The evidence adduced at trial convinces this court beyond any doubt that the jury's verdict is reasonable. Indeed, it defies logic to suggest that, given the evidence, the verdict is not completely meritorious.

Accordingly, the motions by Joe E. Fryar, All American Services Co., Ltd., Wright, Lindsey & Jennings, and Valley Forge Insurance Company for judgments notwithstanding the verdict and for a new trial are hereby DENIED.

Opelousas, Louisiana, March 26, 1986.

/s/ John M. Shaw
JOHN M. SHAW
UNITED STATES DISTRICT JUDGE

UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

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No. 87-4260

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D.C. Docket No. CA-84-1786-0

Edward C. ABELL, Jr. and Carey Walton, Plaintiffs-Appellees Cross-Appellants,

v.

POTOMAC INSURANCE COMPANY, et al., Defendants,

Joe E. Fryar, Wright, Lindsey and Jennings, and Valley Forge Insurance Company, Defendants-Appellants Cross-Appellees.

Appeals from the United States District Court for the Western District of Louisiana

Before THORNBERRY, WILLIAMS, and SMITH, Circuit Judges.

J U D G M E N T
(Filed November 2, 1988)

This cause came on to be heard on the record on appeal and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the District Court in this cause is affirmed in part and reversed in part, and the cause is remanded to the District Court for further proceedings in accordance with the opinion of this Court.

IT IS FURTHER ORDERED that costs on appeal be taxed by the Clerk of this Court as follows: 1) Plaintiffs pay Wright, Lindsey & Jennings's costs; 2) Plaintiffs pay Valley Forge Ins. Co.'s costs; 3) Joe Fryar pays plaintiffs' costs; 4) Joe Fryar bears his own costs; and 5) All American Services, Inc. bears its own costs.

November 2, 1988

ISSUED AS MANDATE: DEC 28 1988

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IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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No. 87-4260

---

EDWARD C. ABELL, JR., and CAREY WALTON

Plaintiffs-Appellees
Cross-Appellants,

versus

POTOMAC INSURANCE COMPANY, Etc., ET AL.,

Defendants,

JOE E. FRYAR and WRIGHT, LINDSEY & JENNINGS and VALLEY FORGE INSURANCE COMPANY,

Defendants-Appellants
Cross-Appellees.

---

Appeal from the United States District Court
for the Western District of Louisiana

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*ON PETITIONS FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC*

(Opinion 11/2/88, 5 Cir., 1986, 858 F.2d 1104)

(December 14, 1988)

Before THORNBERRY, WILLIAMS and SMITH, Circuit Judges.

PER CURIAM:

(x) The Petitions for Rehearing are DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court

be polled on rehearing en banc, (Federal Rules of Appellate Procedure and Local Rule 35) the Suggestion for Rehearing En Banc is DENIED.

( ) The Petitions for Rehearing are DENIED and the Court having been polled at the request of one of the members of the Court and a majority of the Circuit Judges who are in regular active service not having voted in favor of it, (Federal Rules of Appellate Procedure and Local Rule 35) the Suggestion for Rehearing En Banc is also DENIED.

( ) A member of the Court in active service having requested a poll on the reconsideration of this cause en banc, and a majority of the judges in active service not having voted in favor of it, rehearing en banc is DENIED.

ENTERED FOR THE COURT:

/s/ J. Smith
United States Circuit Judge

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF LOUISIANA
LAFAYETTE DIVISION

| | | |
|---|---|---|
| EDWARD C. ABELL, JR., *ET AL.* | * | CIVIL ACTION |
| | * | NO. 84-1786 |
| VERSUS | * | SECTION 'O" |
| POTOMAC INSURANCE COMPANY OF ILLINOIS, *ET AL.* | * | MAGISTRATE DIVISION |

*J U D G M E N T*
(filed February 19, 1987)

This action came on for jury trial before the Court on December 8, 1986, with the Honorable John M. Shaw, District Judge presiding, and the issues having been duly tried and a verdict having been duly rendered in favor of plaintiffs on February 4, 1987;

IT IS ORDERED, ADJUDGED AND DECREED that there be judgment herein in favor of plaintiffs, Edward C. Abell, Jr. and Carey Walton, and the class of purchasers of Westside Habilitation Center Revenue Bonds, and against defendants Joe E. Fryar, All American Services Company, Ltd., Wright, Lindsey and Jennings and Valley Forge Insurance Company jointly and severally in the full and true sum of $6,715,800, together with interest thereon at the rate of 12% from July 5, 1984, the date of judicial demand, until payment, together with taxable court costs and attorneys' fees as set forth below.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that there be judgment herein in favor of all plaintiffs and against defendants Joe E. Fryar, All American Services Company, Ltd., Wright, Lindsey & Jennings and Valley Forge Insurance Company *in solido* in the full and true sum of $1,540,000, with interest thereon at the rate of 12% per annum from date of judicial demand until date of payment, together with taxable court costs and attorneys' fees as set forth below. This portion of the judgment is a part of and encompassed within the award made in the above paragraph. Hence, if recovery is had under the award made in the above paragraph, this portion of the judgment is duplicative and shall not be exigible.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that there be judgment herein in favor of all plaintiffs and against defendants, Joe E. Fryar and All American Services Company, Ltd., jointly and severally in the full and true sum of $2,550,000, together with interest thereon from date of this judgment until date of payment, together with all costs of the suit and attorneys' fees as set forth below.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that there be judgment herein in favor of all plaintiffs and against All American Services Company, Ltd. in the full and true sum of $2,950,000, together with interest thereon from date of this judgment until date of payment.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that there be judgment in favor of all plaintiffs and against Wright, Lindsey and Jennings and Valley

Forge Insurance Company *in solido* in the full and true sum of $300,000, together with interest thereon at the rate of 12% from date of judicial demand until date of payment, together with all costs of these proceedings. This portion of the judgment is also encompassed within and a part of the award made in the first paragraph. Hence, if recovery is had under the award made in the first paragraph, this portion of the judgment is duplicative and shall not be exigible.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that there be judgment in favor of all plaintiffs and against Joe E. Fryar, All American Services Company, Ltd., Wright, Lindsey & Jennings, and Valley Forge Insurance, *in solido*, in the full and true sum of $2,567,323.80, representing reasonable attorneys' fees, together with taxable costs of this proceeding to be determined upon the plaintiffs' submission of their bill of costs. Of this amount, only $2,117,323.00 shall be payable to counsel for plaintiffs and the balance shall be paid to the plaintiffs.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that there be judgment in favor of plaintiffs and against Joe E. Fryar and All American Services Company, Ltd. *in solido* for the full and true sum of $263,743.00, representing costs and expenses of this litigation compensable under the RICO statute but not taxable under 28 U.S.C. 1920. Of this amount, $64,071.29 shall be payable to counsel for plaintiffs and the balance shall be paid to plaintiffs.

OPELOUSAS, LOUISIANA, this 19th day of February, 1987.

ROBERT H. SHEMWELL,
Clerk of Court, United States
District Court for the Western
District of Louisiana
By: /s/ Mildred Baker
Mildred Baker, Deputy Clerk

Approved as to form:

/s/ John M. Shaw
John M. Shaw, United
States District Judge

Judgment entered 2-19-87
By Rita V. Watkins

Judgment Entered 2-19-87

By /s/ Rita V. Watkins

Notice to:

Wittmann
Durio
Hamilton III
Provosty, Jr.
Odom
Smith
Humphries, Jr.
Breaux
Sommer
Stahl
Bienvenu
Melichar
Simon
Alltmont
Goudelocke
Weems III
Stafford, Jr.
Frankhauser
Nunnally, III
Downing
Welch
Davidson
Munsterman
Mayer
Schomp

Trial testimony of David Menz (direct examination) – January 12, 1987

* * *

(p. 13)* * *

Q All right. Now, the primary opinion of underwriter's counsel that's typically expected concerns the adequacy of disclosure, isn't that right?

A That's correct.

Q And to make sure that disclosure is proper, it's incumbent on underwriter's counsel to learn all of the details surrounding the transaction itself, isn't that right?

A That's right.

Q And to do so you have to review all the documentation involved?

A That's right.

Q And the purpose of requiring adequate disclosure is (p. 14) to protect the bondholders? That's the principal purpose of it, is it not?

A Right.

Q Now would you agree with me that you should disclose information that would be deemed important by a reasonable investor in making his investment decision?

A Material facts, that's correct.

* * *

Trial testimony of Paul Gordon
(direct examination) – January 20, 1987

* * *

(p. 81) . . . and were you able to determine whether or not any of those four assumptions that you've just described, the adverse feasibility study, the real estate transaction, the million dollar line of credit and the fact that the developer did not have two million of his own bonds, was that disclosed anywhere in this document?

A It was not disclosed.

Q Okay, sir. Assuming that those facts, those four assumptions that we've given you, were disclosed, do you have any opinion as to whether or not these bonds could have been marketed?

A I do.

Q What is that opinion?

A I believe that if those four facts were disclosed, the bond issue could not have come to market, because I don't think you would have found an underwriting firm that would have put their name on the cover with the facts stated there. And, secondly, with all those facts in there, I think it would have been impossible to market.

Q By market, you mean sell?

A Sell, sell.

* * *

(p. 84) * * *

Q Sir, what about with respect to the remaining two assumptions, particularly the Booz, Allen unfavorable report and the real estate transaction?

A I believe that if the real estate transaction – as it was defined to me, the $100,000.00 resold for a hundred fifty thousand and repurchased substantially the same way it was sold for two and a half million dollars. I don't believe if that had to be put in the prospective [prospectus] that you would have the underwriter who would take the deal. Part of putting your name on that cover is your professional reputation, and I don't think that you would have found someone to take a deal with that type history in it.

The second thing I found that would limit the coming to market is if you disclose a feasibility study that showed the project was not financially viable, I don't think you could sell this.

(p. 85) In start-up ventures like this, there's a substantial failure rate even with a positive feasibility study, so I think those two combined would have prevented a firm from underwriting it and bringing it to market, and if somebody would have put their name on the cover, I don't think you could have sold it.

Q Now, sir, in connection with the purchase of bonds by your firm –

THE COURT: Excuse me. I want to ask you something.

Let's assume that number two, three and four could be overcome, that the adverse feasibility report could have been explained, let's just assume that, and you're left strictly with the sales history of the real estate. What about that one fact alone? What would be your opinion on that?

THE WITNESS: I don't know without extensive explanation how you could bring that forward and say we had a piece of property that started out in an area at $100,000.00 and in a short period of time increased to twenty-five times the value without some explanation, without substantial improvements. I think an underwriter has a responsibility only of reasonableness where he would say how did this come about, and if it was me and I would say we can't put that in here and (p. 86) bring this to market, people would say, why didn't you question this, how are we going to explain? That's the problem with it, finding somebody to put it in there and not feel embarrassed to do so.

BY MR. SCHONEKAS:

Q Had that been disclosed in the oficial statement, do you have any opinion whether or not these bonds could have been marketed, without explanation, simply that the property was resold for two and a half million dollars after it had been purchased for $150,000.00 some three months before?

A Well, my contention is that would have prevented you from getting to the sales stage. I think the underwriters would have had the responsibility to do something.

But if you put that forward, could it have been sold? I guess anything could be sold.

Q Would any reputable underwriter have underwritten this particular issuance, sir, with that transaction?

A In my opinion, not.

* * *

(Cross-examination)

(p. 96) blue lists and things of that sort?

A Blue list is –

Q – and that tells you the price?

A Blue list is an offer side of the market. . . .

* * *

Q And, to your certain knowledge, were the bonds listed in the blue list?

A I think there's always offerings in the blue list.

Q Okay. And were they not all sold for the year 1982? After the first, what, sixty days, there was no more offering?

A No. The bonds in the blue list are a secondary market. If you're referring to was this issue sold on the original offering –

* * *

THE COURT: . . . The bonds were all initially sold at the offering time. The secondary market is for those people that bought those bonds and want to sell them again, and that's carried on the blue list?

THE WITNESS: Yes. Those were the bonds we'd see in the blue list, yes, re-offerings from people who already bought them from the underwriters.

BY MR. SIMON:

Q Now, Mr. Gordon, what was the re-offering in the blue list?

(p. 98) A Excuse me?

Q What was the re-offering price in the blue list in, let's say, June, July, August of 1982?

A I would say for most of that period the re-offering price would have been approximately par, a hundred cents on the dollar.

Q I think you said that they sold at that price, is that correct?

A When I say sell, I may not be looking at it from the same angle you do. I look at the bid side, the wholesale price of the market, what a client would sell it to us for rather than what we would re-sell it for.

Q Mr. Gordon, I'm not interested in what your prospective is.

Didn't you testify, tell the ladies and gentlemen of the jury, that sixty days after July 5, 1982 these bonds were selling for par?

A Within five points of par is what I think I said.

Q You said par to ninety-five?

A That's within five points of par. Ninety-five is within five points of par. Par is a hundred. Hundred take away five, ninety-five.

Q That's helpful.

Was it your testimony then that it sold at ninety-five and never at par?

(p. 99) A No, that was not my testimony. I was just trying to give you a range that bonds were trading within.

Q So they were selling at par as well as ninety-five

A That is correct.

Q That's what I thought you had said, that some sold at par, right?

A That is correct.

Q So let me ask you as to par.

It's true, is it not, that the fourteen percent bond never did sell at par, did it?

A Excuse me. When I was giving that price, that all related to the sixteen and a half percent bonds which were issued at par. The fourteen percent bonds were always at a discount, and even ninety cents would be a premium for them, so all of my testimony related to the sixteen and a half percent bond. If I was confusing in that, I'm sorry.

* * *

(p. 108) * * *

MR. SCHONEKAS: Same objection, Your Honor. What the bonds are trading for today I don't think is relevant. It's the value at the date, at the time of the issuance. What they're trading for today, as I understand the Court's ruling, has nothing to do with the value at the time of issuance.

THE COURT: Probably not, but I'm going to let him answer the question. We might as well get all the information.

BY MR. SIMON:

Q Notwithstanding the bankruptcy proceedings and that they're out of bankruptcy and the guaranteed interest rate is less than what it was with a contingency obligation to pay later, notwithstanding the filing of this lawsuit, these bonds are trading on the market today, aren't they?

A Yes, they are.

Q. And right now they're listed in the blue list, for example?

MR. SCHONEKAS: Same objection, Your Honor.

BY MR. SIMON:

Q They're listed in the blue list right now? For (p.109) example, the fourteen percent, it's a fact, is it not, that the fourteen percent bonds are listing at a higher price than they listed on the day they were issued? Is that correct, to your certain knowledge?

A What is the price in the blue list?

Q Aren't they listed today on the blue list at a price higher than the price they were sold for when they were issued in 1982?

A I would say about the same.

Q About the same. So they're selling for about the same price?

A That is correct.

* * *

UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

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No. 86-7790

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ERNEST ROSS and GEORGE MILLER, Individually and as Representatives of a Bondholder Class,

Plaintiffs-Appellants,

v.

ARTHUR M. RICE, JR., *et al.*,

Defendants-Appellees.

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On Appeal from the United States District Court
for the Northern District of Alabama

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# IN BANC BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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UNITED STATES COURT OF APPEALS
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On Appeal from the United States District Court
for the Northern District of Alabama

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# IN BANC BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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## *STATEMENT OF JURISDICTION*

As amicus curiae, the Securities and Exchange Commission takes no position with respect to this Court's jurisdiction to hear this appeal.

## *STATEMENT OF THE ISSUES PRESENTED*

1. Whether indirect proof of reliance should be allowed in federal securities law fraud cases involving public securities offerings, where the securities would not have been marketed except for the fraud, and where the

plaintiff relied on the market not to support the sale of unmarketable securities.

2. Whether, in such cases, the plaintiff should enjoy a rebuttable presumption of reliance on the market not to support the sale of unmarketable securities.

## *INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION*

The Securities and Exchange Commission is the agency responsible for the administration and enforcement of the federal securities laws, including the anti-fraud provisions of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. The Commission submits this brief as amicus curiae to address the issue whether a plaintiff in a private fraud action under those provisions may prove reliance indirectly, in cases involving a public offering of securities, where (1) the securities were rendered marketable only as a result of the fraud and (2) the plaintiff relied on the market not to support the sale of unmarketable securities, as well as the issue whether such a plaintiff is entitled to a rebuttable presumption that he so relied on the market.

While these issues do not arise in Commission actions, in which reliance need not be shown, they often are important in private fraud actions to enforce the federal securities laws – actions which are an essential supplement to the Commission's enforcement of the securities laws. *See Basic Inc. v. Levinson*, 108 S. Ct. 978, 983 (1988). The Commission urges this Court to allow proof

of indirect reliance in cases in which a plaintiff alleges that fraud in a public securities offering rendered the securities marketable and that he relied on the market not to support the sale of unmarketable securities, and to apply a rebuttable presumption of such reliance on the market. The theory and presumption are well-supported by logic and are consistent with, and help further, the purposes of the federal securities laws of assuring that the markets for public offerings are honest and not a breeding ground for fraud.

## *STATEMENT OF THE CASE*

### A. *The Proceedings Below*

The plaintiffs in this action are purchasers of tax-exempt municipal bonds who allege, *inter alia*, that defendants perpetrated a fraudulent scheme to issue and sell the bonds, in violation of Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act, and Commission Rule 10b-5 thereunder. The plaintiffs, asserting a theory of indirect reliance articulated by this Court's predecessor in *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (*en banc*), *cert. denied*, 459 U.S. 1102 (1983), claim that the defendants' scheme fraudulently caused otherwise unmarketable bonds to be brought to market, and that the plaintiffs, and a class of other persons, purchased the bonds in reliance on the market not to support the sale of unmarketable securities. The district court certified the action as a class action, limited to persons who purchased bonds prior to their default in 1984, and who asserted a *Shores* theory of reliance. [1985-86] Fed. Sec. L. Rep. (CCH) ¶ 92,526 (N.D. Ala. 1986). The district court

subsequently dismissed the claims as to certain defendants, and granted summary judgment in favor of the remaining defendants. [1986-87] Fed. Sec. L. Rep. (CCH) ¶ 92,948 (N.D. Ala. 1986).

On appeal, a panel of this Court affirmed the district court's class certification, and reversed in part and affirmed in part the district court's decision on the merits, remanding the case to the district court for further proceedings. 837 F.2d 980. On March 24, 1988, this Court ordered rehearing *en banc*.

B. *Facts*[1]

The bonds in this case were issued by the Special Care Facilities Financing Authority created by the City of Vestavia Hills, Alabama. Complaint ¶¶ 12, 13, 49-51 (R.E. 11, 26-7). The bonds were sold in a public offering in 1981 to finance the construction of a residential/medical facility for the elderly. Complaint ¶¶ 4, 64 (R.E. 7-8, 31). In 1984, the facility filed for bankruptcy, and the bond issue went into default. Complaint ¶ 4 (R.E. 7-8). The plaintiffs allege that the defendants fraudulently issued the bonds through the use of a disclosure statement that materially misrepresented or failed to disclose to the public that there had been past failures to obtain financing for the project, that the prices for housing units in the facility had been increased beyond what the housing market

1. The following facts are derived from the plaintiffs' complaint. The Commission expresses no view on the facts or disposition of this case. "R.E." refers to the Record Excerpts filed in this action.

could bear, that the developers had inflated the number of pre-sold apartments – to meet a requirement that 50% of the units be sold prior to the bond offering – through what plaintiffs allege were sham transactions, and that the bonds did not qualify as tax-exempt. Complaint ¶¶ 37-42, 75, 78-83 (R.E. 22-4, 34-40). Plaintiffs also allege other fraudulent conduct. Complaint ¶¶ 87-91 (R.E. 41-2). The plaintiffs contend that these and other alleged facts made it clear that the bond issue was doomed to default, and that, had these facts been known, the bonds would have been unmarketable. Complaint ¶ 84 (R.E. 40).

The plaintiffs purchased the bonds without reading the allegedly fraudulent disclosure statement prepared in connection with the offering of the bonds. The plaintiffs nonetheless allege reliance on the fraudulent scheme. The plaintiffs base their claim on *Shores*, which held that a private securities fraud plaintiff who buys securities in a public offering can show indirect reliance on a fraudulent course of conduct by the offerors, even if he has not read a fraudulent disclosure statement, if the securities would not have been marketed except for the fraud, and he purchased in reliance on the market not to support the sale of such securities. *See* 647 F.2d at 464.

The district court, applying *Shores*, certified the class, but then dismissed the claims on the merits as to the City of Vestavia Hills, Alabama, the Special Care Facilities Financing Authority and the trustees of the project. It subsequently granted summary judgment in favor of the

remaining defendants,[2] concluding that there was no evidence from which a jury could reasonably infer a scheme to bring securities on the market which were not entitled to be marketed. *Ross v. Rice*, [1986-87] Fed. Sec. L. Rep. (CCH) ¶ 92,948 (N.D. Ala. 1986).

The plaintiffs appealed the dismissal and grant of summary judgment. The defendants cross-appealed, challenging the certification of the class. The defendants did not dispute that, under *Shores*, a plaintiff may prove reliance indirectly in the circumstances alleged here. They claimed, however, that the two named class representatives were subject to the "unique" defense "that they did not rely on the integrity of the market in purchasing the bonds," and thus were not adequate class representatives. 837 F.2d at 990. On appeal, the panel held that *Shores* allows proof of reliance indirectly on the facts alleged here, that the two class representatives could on the facts here allege reliance on the market, and that the district court acted within its discretion in certifying the class. *Id.* at 990-98.

On March 24, 1988, this Court granted rehearing *en banc*, and directed the parties to address whether this Court should continue to follow *Shores*.

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2. The remaining defendants are (1) Arthur Rice, developer of the project for which the bonds in controversy were issued; (2) Herreth, Orr & Jones, the underwriter; (3) Alston & Bird, successor firm of Jones, Bird & Howell, bond counsel, and Peter Wright, attorney, individually; (4) Laventhol & Horwath, feasibility consultant; and (5) the Wellington Corporation, the Finerock Corporation, and Robinson-Hall, Inc., who were parties to a joint venture formed to develop the project.

## *SUMMARY OF ARGUMENT*

The Commission urges this Court to continue to apply *Shores* to allow indirect proof of reliance in cases where securities in a public offering were rendered marketable only as a result of fraud and the plaintiff relied on the market not to support the sale of unmarketable securities. The *Shores* theory of indirect reliance is strongly rooted in logic. It rests first on the proposition that, in some cases, a fraud committed in a public offering may be so extensive that it is only because of the fraud that the securities were offered on the market at all. This can be shown either by demonstrating that the securities were worthless, and thus but for the fraud would not have been bought by purchasers at any price, or by demonstrating that even if purchasers might have been willing to buy the securities at some price, they would not have been placed on the market by the offeror at that price.

The second prong of the *Shores* theory, that investors rely on the market not to support the sale of unmarketable securities, is a matter of common sense. Investors would not participate in a market if they knew that the very presence of the securities on the market was a product of fraud. That view is consonant with the fundamental premise of the Securities Act that investors would not participate in markets that offered securities through fraud, and that capital formation would be impaired unless the markets were honest. For these reasons, furthermore, this Court should hold that a plaintiff enjoys a rebuttable presumption that he relied on the market not to support the sale of unmarketable securities.

The policy arguments that have been made against allowing proof of indirect reliance are without foundation. The first argument, that the theory dispenses with the reliance requirement in securities fraud actions, is not correct. Although the theory allows indirect proof of reliance, it still requires reliance. Nor is it true that allowing indirect reliance contravenes the disclosure objectives of the federal securities laws. The securities laws seek to compel issuer disclosure, not to compel each investor to read all disclosures, where there are means by which the investor may reasonably rely indirectly on the disclosures. Nor would requiring proof of direct reliance encourage the reading of issuer disclosures. Investors do not invest in securities with the thought of buying into a fraud suit, and do not read issuer disclosures with the idea that they are thereby preserving a cause of action. On the other hand, eliminating indirect reliance would effectively immunize persons who perpetrate fraud from liability to investors who relied on their fraud, but did not happen to read the disclosure document, thereby lessening the incentive for full and accurate disclosure.

## *ARGUMENT*

### I. A PLAINTIFF IN A FEDERAL SECURITIES LAW FRAUD CASE SHOULD BE ALLOWED TO ESTABLISH RELIANCE INDIRECTLY WHERE (1) SECURITIES IN A PUBLIC OFFERING WERE RENDERED MARKETABLE ONLY AS A RESULT OF THE FRAUD AND (2) THE PLAINTIFF RELIED ON THE MARKET NOT TO SUPPORT THE SALE OF UNMARKETABLE SECURITIES.

This case raises the issue whether a plaintiff in a fraud action under the federal securities laws should be

allowed to demonstrate reliance in an indirect fashion, in cases where a pervasive fraudulent scheme has allowed an otherwise unmarketable public offering of securities to be marketed, and where the plaintiff relied on the market not to support the sale of unmarketable securities. This Court's predecessor, the old Fifth Circuit, held *en banc* in *Shores v. Sklar* that a plaintiff could, in such a case, show reliance indirectly.[3]

The issue is *not* whether it is appropriate to dispense with the requirement that the plaintiff in a private fraud action under the federal securities laws have relied on the

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3. In addition to *Shores*, the indirect reliance theory has been applied in other appellate cases involving public offerings. *See Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1221 (1988); *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330, 1333 (10th Cir.), *cert. denied*, 465 U.S. 1026 (1983), ("Federal and state regulation of new securities at a minimum should permit a purchaser to assume that the securities were lawfully issued"); *Sanders v. John Nuveen & Co., Inc.*, 619 F.2d 1222, 1226-27 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981) (the lack of evidence as to each purchaser's receipt of a misleading prospectus was irrelevant in showing causation because such prospectuses had been distributed to certain purchasers and publication of the actual facts "would have caused a total collapse of the market" for the commercial paper involved).

The following district court cases also have followed *Shores*: *Goldwater v. Alston & Bird*, 116 F.R.D. 342 (S.D. Ill. 1987); *Koehler v. Pulvers*, 614 F. Supp. 829, 848 (S.D. Cal. 1985); *Rose v. Arkansas Valley Environmental & Utility Authority*, 562 F. Supp. 1180, 1205-06 (W.D. Mo. 1983); *Dekro v. Sterns Bros. & Co.*, 540 F. Supp. 406, 412-13 (W.D. Mo. 1982); *Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730, 736-37 (W.D. Va. 1982).

defendant's fraud. The Supreme Court has made it clear, in *Basic, Inc. v. Levinson*, 108 S. Ct. 978 at 989, "that reliance is an element of a Rule 10b-5 cause of action." As the Court explained: "[r]eliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." *Id.* (citations omitted).

The issue, rather, is whether reliance can in certain circumstances be shown to have occurred indirectly. As a general proposition, there is no doubt that reliance need not always be direct. As the *Basic* Court recognized: "[t]here is * * * more than one way to demonstrate the causal connection." *Id.*

In *Basic* the Court recognized that in one context – securities trading in an active secondary market – a plaintiff could show indirect reliance by means of the so-called "fraud-on-the-market" theory.[4] The Court held that where fraudulent information about a company is disseminated into an active market for a company's stock, the information will distort the stock's price,[5] and that investors buying or selling in such markets generally rely

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4. The "fraud-on-the-market" theory of indirect reliance in secondary market trading had previously been accepted by every court of appeals to have considered it, including this Court. *See Basic*, 108 S. Ct. at 991 & n.25; *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985).

5. Thus, the Court accepted the efficient capital market theory – that stock prices in active secondary markets reflect information disseminated into the market. *See* 108 S. Ct. at 991 & n.24.

on the market not to be distorted in that fashion. As a result, when they buy or sell in a market that has been distorted by fraudulent statements, they indirectly rely on the statements. The market, in effect, incorporates and "transmits" the fraud to the investor. *See id.* at 990 (citing *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

This case involves a different theory of indirect reliance, first articulated in *Shores*, arising in the context of a different type of market – the undeveloped market for an issuer's initial public offering of securities.[6] It is a theory that has at times also been called, and was called by the *Shores* court, a "fraud-on-the-market" theory, in recognition of the fact that, like the theory applied in *Basic*, it rests on a fraud being perpetrated on a market and on the plaintiff relying on the market (and thus indirectly on the fraudulent statements and/or conduct). But, in other respects, the theory at issue in this case is different from *Basic*'s fraud-on-the-market theory, and for clarity this brief will not use that phrase to refer to it.

The errors in logic generated by this confusion of terminology are evident from the briefs of defendants and amicus curiae. The briefs rely heavily on the contention that, because the "fraud-on-the-market" theory in *Basic* rests on the efficient capital market hypothesis, and thus only applies to efficient secondary markets, the "fraud-on-the-market" theory cannot be applied in this

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6. The fraud-on-the-market theory adopted in *Basic* might apply in situations where an issuer makes an offering of securities for which an active secondary market already exists, such as where a company issues additional shares of its common stock. The *Shores* theory is only necessary where there is no such market for the securities.

case, which does not involve an efficient secondary market. But the theory advanced here, although in some respects analogous to the *Basic* theory, is *not* the same theory applied in *Basic*, and does not, as discussed below, rest on the efficient capital market hypothesis. The theory at issue here was not at issue, and thus was not discussed, let alone rejected, in *Basic*.[7]

Although the *Shores* theory of indirect reliance is different from that adopted in *Basic*, it is at least as strongly rooted in logic. First, where *Basic* begins with the proposition (supported by empirical evidence) that fraudulent information distorts securities prices in active secondary markets, the *Shores* theory begins with what should be if anything a less controversial proposition – that in some cases a fraud committed in a public offering may be so extensive that it is only the fraud that makes the securities marketable. Unlike the *Basic* theory, which requires an assessment of the relation between fraud and securities prices, the *Shores* theory simply requires recognizing that there may be cases where the plaintiff can show that, had the true state of affairs been known, the security would not have been marketed at all.

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7. Neither the majority nor the dissent in *Basic* discussed *Shores*. Defendants' and amicus' suggestion that *Basic* "implicitly rejected" *Shores*, based on Justice White's statement in his dissent that the majority had "implicitly rejected" certain "wrong turns" taken by lower courts, 108 S. Ct. at 995, is incorrect. It is apparent, from the opening portion of Justice White's opinion, *see id.* at 993-94, that he was referring to the majority's rejection of certain cases that had allowed reliance to be eliminated as an element of a fraud action.

In *Shores* the court stated that the theory would apply where the fraudulent scheme "was so pervasive that without it the issuer would not have issued, the dealer could not have dealt in, and the buyer could not have bought [the securities], because they would not have been offered on the market at any price." 647 F.2d at 464 n.2. The notion that the securities "would not have been offered on the market" encompasses two possibilities. The first is that the securities would not have been placed on the market because they were worthless and thus would not have been bought by purchasers at any price, regardless of how low. The second concept is that even if purchasers might have been willing to buy the securities at *some* price, they would not have been placed on the market by the offeror at that price. As the panel noted in this case (837 F.2d at 1002):

> Defendants do not prevail merely because they can show that the public would have purchased these bonds at some price absent fraud. This focus solely on bond *purchasers* is not helpful. The lower price or higher rate which buyers would accept is only relevant if the bonds would be offered at that price or rate by non-fraudulent sellers of securities. The issue is whether bond *sellers (i.e.,* underwriters, developers, etc.) would have been able to price these bonds without fraud at a price and rate which would attract informed buyers.[8]

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8. Presumably, the question whether the securities could have been placed on the market at a price that would have been acceptable to *both* the offeror and purchasers can be demonstrated by testimony from underwriters and other expert market participants.

Once it is shown that the securities were unmarketable, the second prong of the *Shores* theory is that investors rely on the market not to support the sale of unmarketable securities, something that also is at least as acceptable as the analogous prong of the *Basic* theory. In *Basic*, the Court held that investors rely on the integrity of the active secondary market in setting prices. It noted that nearly every court to have considered the proposition, including this Court in *Lipton*, had accepted that "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." *Id.* at 991-92.

In contrast, the *Shores* theory does not require that investors rely on the market to assure honesty in setting securities prices. It only requires that investors rely on the market to serve the more modest function of not allowing unmarketable securities to be sold at all. The *Basic* Court found it a matter of common-sense that investors would not participate in a market where prices are the product of fraud; it is even more a matter of common-sense that investors would not participate in a market where the very presence of the securities on the market was a product of fraud.

Indeed, it is the fundamental premise of the Securities Act that investors would not participate in markets that offered securities through fraud, and that capital formation would be impaired unless the markets were honest. As the Senate Report accompanying the Securities Act stated, the aim of the Act was "to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation * * *" (S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933)).

Likewise, the House Report stated that the Act was intended to redress the situation in which thousands of persons had invested money in "worthless securities", and to prevent "the flotation of * * * a mass of essentially fraudulent securities * * *" (H. Rep. No. 85, 73d Cong., 1st Sess.2 (1933)). Congress intended by the Securities Act to restore "those standards of fair, honest, and prudent dealing which should be basic to the encouragement of investment in any enterprise." *Id.*[9]

The *Shores* theory of indirect reliance, in short, is justified in circumstances where fraud is responsible for bringing a securities offering to market in the first place and where investors rely on the market not to support the

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9. Defendants Rice and Wellington Corporation (Br. 27-29) contend that to allow investors to rely on the market not to support the sale of unmarketable securities is to impose a system of merit regulation of the sort rejected by Congress in adopting the Securities Act. But what Congress rejected was a system of *government* merit regulation. The Securities Act leaves it to the market to judge the merit of any security. That is true of *Shores* as well. What a *Shores* plaintiff must show is that had fraud not been committed, and had the truth been known about the securities, *the market* would have judged the securities' merit, and not supported their sale. In addition, the theory does not, as those defendants suggest (Br. 27), state that unmarketability constitutes fraud. Under *Shores* the securities must *first* be found to have been marketed by fraud, and then found that, but for the fraud, they would not have been offered and/or accepted on the market.

sale of unmarketable securities.[10] In such circumstances the market is defrauded and investors, relying on the market, indirectly rely on the fraud.

Ten of the twenty-two judges on the *Shores* court dissented. The arguments the *Shores* dissent presented against adoption of the theory, however, do not go so much to the logic of the theory as they do to policy

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10. There is a broader theory of indirect reliance that could be urged with respect to securities transactions in a market for a public offering. That theory would allow proof of indirect reliance even in circumstances where the fraud is not responsible for the securities being marketable, but only affects the price at which the securities are sold. The theory would be that fraud affects the price which prospective purchasers are willing to pay for the securities and distorts the price at which the underwriters, assessing market interest and other factors, will put the securities on the market. It would further rest on the view that investors buying securities in a public offering rely on the market and the underwriters to perform that price setting function honestly.

In *Shores*, the court rejected that broader theory because the court believed that denying recovery in those circumstances, absent direct reliance, would encourage investors to read disclosure documents. As discussed below, we believe that such a policy concern is overstated at best. The Commission does not, however, urge this Court to adopt or reject the broader theory, but instead urges it to reserve judgment on the theory until it is presented in a future case. The theory raises questions, especially in the context of municipal securities, not presented here, about the relation between fraud and the price of securities in a public offering. Those issues have not been developed in this case, which rests only on the narrower theory that the fraud was responsible for rendering the securities marketable.

arguments that also were raised and rejected (nineteen days after the panel's decision in this case) in *Basic*.

First, the *Shores* dissent suggested that the theory dispenses with the reliance requirement in securities fraud actions. This suggestion is as incorrect here as it was when made and rejected in *Basic*. Although the *Shores* theory allows indirect proof of reliance, it still requires reliance. Indeed, as the *Shores* dissent noted, under the fraud-on-the-market theory in secondary markets, a defendant can nonetheless prevail by showing that the plaintiff did not rely on the fraud, in the sense either that he knew of the falsity or that, had he known, he would have traded in the securities anyway. Precisely the same should hold true under the *Shores* theory. If the plaintiff knew of, or was indifferent to, the fraud, he should not recover.[11] But the mere fact that the plaintiff did not *directly* rely on the fraud hardly shows such indifference where the plaintiff in fact indirectly relied through the mechanism of the market.

The Shores dissent also viewed requiring direct reliance as a means of promoting the disclosure objectives of the federal securities laws. The dissent stated (647 F.2d at 483):

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11. The *Shores* dissent appears to have concluded that the majority's theory would allow recovery even where the plaintiff *was* indifferent to the fraud, and thus distinguished that theory from the fraud-on-the-market theory. We do not read the *Shores* theory as going that far, nor would it be appropriate to do so. The majority made it clear (647 F.2d at 472) that it was allowing an action only where there was reliance by alternative means.

> the reliance requirement is intended to encourage investors to base their investment decisions on information required by the securities laws to be disclosed. In short, the federal securities laws are intended to put investors into a position from which they can help themselves by relying upon disclosures that others are obligated to make. This system is not furthered by allowing monetary recovery to those who refuse to look out for themselves. If we say that a plaintiff may recover in some circumstances even though he did not read and rely on the defendants' public disclosures, then no one need pay attention to those disclosures and the method employed by Congress to achieve the objective of the 1934 Act is defeated.

This reasoning is flawed in several respects. To be sure, a primary objective of the federal securities laws is to compel full and accurate disclosure by issuers, so as to make the information available to the market.[12] But the disclosure objectives of the statutes do not necessarily require in all circumstances that each investor read all issuer disclosures. There is no reason why investors cannot, consistent with Congress' objective, rely in certain circumstances on the market to process and evaluate issuer disclosures. The *Shores* dissent fails to explain why

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12. The Supreme Court has observed that a "fundamental purpose" of the federal securities laws, including the Securities Act and Securities Exchange Act, "was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). *See Basic*, 108 S. Ct. at 982.

investors who reasonably rely on the market to perform that function are not "look[ing] out for themselves."[13]

Even were it assumed, however, that individual reading of the documents is superior to relying on the market's assessment of the documents, the contention that restricting recovery will encourage reading documents is at best overstated. Investors do not buy securities in order to buy into a lawsuit and will not tailor their reading of the disclosure documents according to

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13. The dissent alternatively may have been suggesting that in public offerings, unlike in transactions in secondary trading markets, the registration provisions of the Securities Act require that all mandated information be made available directly to individual investors and that even in unregistered offerings, a disclosure document is likely to be available to prospective purchasers. Thus, arguably, there is less of a need in the initial offering context for the investor to rely on the integrity of the offering process to evaluate relevant information, since it is readily available to the investor.

But even where securities are registered under the Securities Act, the Act normally only requires delivery of the prospectus at the time of delivery of the confirmation of the sale (*see* Section 5(b)(2) of the Securities Act, 15 U.S.C. 77e(b); 1 L. Loss, *Securities Regulation* 182 (2d ed. 1961)). Moreover, there is no assurance that a prospectus will be available in an offering, such is as at issue here, which is exempt from the registration provisions. And it is precisely in the context of exempt securities, and most specifically municipal securities, that the theory of indirect reliance with respect to a public offering is likely to be raised. With respect to offerings of securities other than municipal securities, the express remedies of Sections 11 and/or 12(2) of the Securities Act, 15 U.S.C. 77k and 771(2) – which do not require proof of reliance – are available.

whether they might recover in such a suit. As the *Basic* Court noted (108 S. Ct. at 991 n.23):

> the incentive for investors to "pay attention" to issuers' disclosures comes from their motivation to make a profit, not their attempt to preserve a cause of action under Rule 10b-5. Facilitating an investor's reliance on the market, consistently with Congress' expectations, hardly calls for "dismantling the federal scheme which mandates disclosure."

Indeed, if eliminating indirect reliance would have any effect it would be to immunize persons who perpetrate fraud from liability to investors who in fact relied on their fraudulent conduct, but who did not happen to read the disclosure document. Such a result could only lessen the incentives for full and accurate disclosure and honesty by such perpetrators.

In contrast, allowing recovery by persons who were in fact defrauded through the reasonable reliance on a market which was the product of fraud, wiil ensure that persons who perpetrate such fraud remain liable for the damages to investors they defrauded. By making liability of such perpetrators co-extensive with the harm they cause, the *Shores* theory will discourage fraud and help ensure the honest markets for public offerings envisioned by the Securities Act.

## II. IT IS APPROPRIATE TO APPLY A REBUTTABLE PRESUMPTION THAT THE PLAINTIFF RELIED ON THE MARKET NOT TO SUPPORT THE SALE OF UNMARKETABLE SECURITIES.

A related question raised by this case is where the burden of proof should lie as to the reliance on the

market. In *Basic*, the Supreme Court discussed the reasons why presumptions may be appropriate, noting that they "[a]ris[e] out of considerations of fairness, public policy, and probability * * *." 108 S. Ct. at 990. The Court held that, in the context of the fraud-on-the-market theory in an active secondary market presented there, it was proper to presume, subject to rebuttal, both that (1) materially false or misleading information disseminated into an active secondary market affects the prices in those markets and (2) investors trading in active secondary markets rely on the integrity of the price setting mechanism of those markets. The Court held that both prongs of the presumption were "supported by common sense and probability." 108 S. Ct. at 991.[14]

The Court stated, furthermore, that these presumptions were consistent with the policy underlying the Securities Exchange Act, in that Congress expressly believed that vigorous trading in securities depends on investor reliance on the integrity of the securities markets, and that false information disseminated into the markets would distort their operation. *See id.* at 990-91.

Under the theory of indirect reliance presented in this case, a presumption is only partly appropriate. The first prong of the theory here is that, as a result of the defendant's fraud, otherwise unmarketable securities were marketed. Unlike the first presumption applied in

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14. The Court noted that empirical studies confirmed that the price of shares in active markets reflected all publicly available information, including any materially false or misleading information. The Court also noted that it was a matter of common sense that investors rely on the integrity of the market when they trade, since no one would knowingly participate in a "crooked game." *Id.*

the active secondary market context – that *any* material false or misleading information disseminated into an efficient market has *some* effect on securities prices – it does not comport with common sense or empirical evidence to presume that *every* fraud renders securities marketable where they otherwise would not have been.[15] That is the sort of factual issue which can only be resolved on a case-by-case basis and as to which the burden should be on the plaintiff.

It is, however, appropriate to apply a presumption with respect to the second prong of the theory, that investors rely on the market for a public offering not to support the sale of unmarketable securities. The *Basic* Court noted that it is common sense to presume that investors in an active secondary market believe the market to be honest and rely on the fact that it is not being distorted by fraud. As noted, it is if anything even more a matter of common sense that investors buying in a public offering rely at a minimum on the proposition that the securities they are being sold are marketable. As the panel held in this case (647 F.2d at 995):

> It is common sense that purchasers do not ordinarily seek to purchase a loss in the form of a fraudulently marketed bond. Consequently, once the plaintiff proves that the deception was material (that is without it the bonds would not have been marketed), reliance on the integrity of the market is presumed.

That presumption is, furthermore, consistent with the Congressional objective, in adopting the Securities Act,

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15. Indeed, as the panel in this case observed, that the securities were only marketable because of the fraud "is a difficult fact to prove." 837 F.2d at 1002.

that the process of raising capital through securities offerings must be honest and untainted by fraud and manipulation in order to function.[16] As discussed above, Congress recognized in adopting the Securities Act that investor reliance on the honesty of the public offering process was essential to raising investment capital, and enacted a system of regulation designed to allow investors to place their reliance on the market. A presumption that investors rely on the market not to offer "worthless" and "essentially fraudulent" securities is fully consistent with the Congressional plan (*see* p. 15, *supra*).

Adoption of the *Shores* theory, and its accompanying presumption of reliance, serves to further that statutory goal of honest markets for securities offerings. As this Court noted with respect to the fraud-on-the-market theory in secondary markets, "[t]he theory thus actually facilitates Congress' intent * * * by enabling a purchaser to rely on an expectation that the securities markets are free from fraud." *Lipton v. Documation, Inc.*, 734 F.2d at 748, cited with approval in *Basic Inc. v. Levinson*, 108 S. Ct. at 991 n.25. Furthermore, to the extent that the theory and presumption allow private securities fraud actions to be

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16. Even where, as here, the securities are exempt from registration, the anti-fraud provisions of Section 17(a) of the Securities Act, as well as the anti-fraud provisions of Section 10(b) of the Exchange Act, evince Congressional recognition that the capital markets cannot function unless they are honest, and are believed by investors to be honest.

prosecuted more efficiently, the enforcement of the federal securities laws, and the underlying goal of honest markets, are furthered.[17]

Although a presumption of reliance on the market is appropriate, it should be rebuttable. One means of rebutting the presumption, suggested by the panel in this case, would be to demonstrate that a plaintiff's reliance on the market was unreasonable, in the sense that he "intentionally refuse[d] to investigate known or obviously present risks associated with the bonds." 837 F.2d at 995, citing *Shores*, 647 F.2d at 470 n.6. A second means, not discussed by the panel, would be to demonstrate that the plaintiff was in fact indifferent to the fraud – that is, that he would have bought the securities even if he had known of the fraud. These are, essentially, the two means of showing non-reliance that the dissent in *Shores* spoke of approvingly; recovery can be defeated by showing either that the plaintiff knew of the fraud, or that he was indifferent to it. *See* 647 F.2d at 479.[18] Where such "positive proof of non-reliance" (*id.*) is lacking, however, the

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17. As the *Basic* Court reiterated, private actions under Rule 10b-5 "constitute[] an essential tool for enforcement of the 1934 Act's requirements." 108 S. Ct. at 983 (citations omitted). *See also Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

18. The *Shores* dissent mentioned these means of proving nonreliance in the course of discussing the fraud-on-the-market theory applied in active secondary markets. *See* 647 F.2d at 478-79. They are, however, equally applicable to the *Shores* theory (*see* n.11, *supra*).

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plaintiff should be entitled to the reasonable presumption that he did rely on the market.

## *CONCLUSION*

For the foregoing reasons, this Court should hold that a plaintiff in a federal securities law fraud case involving a public offering of securities may prove reliance indirectly, where the fraud caused the securities to be marketable and he relied on the market not to support the sale of unmarketable securities. This Court should further hold that, in such a case, a plaintiff enjoys a rebuttable presumption that he so relied on the market.

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A third means of rebutting the fraud-on-the-market theory in secondary markets is to show that the fraud had no effect on the market. Under the *Shores* theory, the plaintiff bears the burden of proof that the fraud *did* affect the market, so that means of rebuttal obviously is not applicable.

**15 U.S.C. § 78j. Manipulative and deceptive devices**

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

June 6, 1934, c. 404, Title I, § 10, 48 Stat. 891.

**17 C.F.R. § 240.10b-5 Employment of manipulative and deceptive devices.**

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

(Sec. 10; 48 Stat. 891; 15 U.S.C. 78j)

[13 FR 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951]

**Federal Rules of Civil Procedure**

**Rule 23. Class Actions.**

(a) PREREQUISITES TO CLASS ACTION. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(b) CLASS ACTIONS MAINTAINABLE. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

(c) DETERMINATION BY ORDER WHETHER CLASS ACTION TO BE MAINTAINED; NOTICE; JUDGMENT; ACTIONS CONDUCTED PARTIALLY AS CLASS ACTIONS.

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits.

(2) In any class action maintained under subdivision (b)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude the member from the class if the member so requests by a specified date; (B) the judgment, whether favorable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if the member desires, enter an appearance through counsel.

(3) The judgment in an action maintained as a class action under subdivision (b)(1) or (b)(2), whether or not favorable to the class, shall include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under subdivision (b)(3), whether or not favorable to the class, shall include and specify or describe those to whom the notice provided in subdivision (c)(2) was directed, and who have not requested exclusion, and whom the court finds to be members of the class.

(4) When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and each subclass treated as a class, and the provisions of this rule shall then be construed and applied accordingly.

(d) ORDERS IN CONDUCT OF ACTIONS. In the conduct of actions to which this rule applies, the court may make appropriate orders: (1) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument; (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action; (3) imposing conditions on the representative parties or on intervenors; (4) requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent persons, and that the

action proceed accordingly; (5) dealing with similar procedural matters. The orders may be combined with an order under Rule 16, and may be altered or amended as may be desirable from time to time.

(e) DISMISSAL OR COMPROMISE. A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs.